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No. 95-___

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
Petitioner,

v.

STATE OF NEW JERSEY, COMMISSIONER OF INSURANCE, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the Superior Court of New Jersey, Appellate Division

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a state may, consistent with the Fifth and Fourteenth Amendments to the United States Constitution, reduce a regulated firm's returns below the reasonable cost of capital.

2. Whether a state may, consistent with the Fifth and Fourteenth Amendments to the United States Constitution, require a regulated firm to pay taxes but refuse to provide a clear and certain after-the-fact procedure to determine whether those taxes are confiscatory.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

Petitioner and plaintiff-appellant below State Farm Mutual Automobile Insurance Company is a mutual insurer owned by its policyholders. It has no non-wholly owned subsidiaries.

Respondents and defendants-appellees below are the State of New Jersey; Elizabeth E. Randall (successor to Samuel Fortunato), Commissioner of Insurance of the State of New Jersey; James J. Ciancia (successor to Edward J. Dauber), Acting Attorney General of the State of New Jersey; Brian W. Clymer (successor to Samuel Crane), Treasurer of the State of New Jersey; and Neil Pearson (successor to Marshall Selikoff), Acting Trustee of the New Jersey Full Insurance Underwriting Association. The Property Liability Insurance Guaranty Association was also a defendant below.

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PETITION FOR A WRIT OF CERTIORARI

State Farm Mutual Automobile Insurance Company petitions for a writ of certiorari to review the judgment of the Superior Court of New Jersey, Appellate Division, entered in this case on May 12, 1995.

OPINIONS BELOW

The opinion of the Superior Court, Appellate Division, is unreported and is reprinted in the appendix hereto ("App.") at 1a. The decision of the Commissioner of Insurance is unreported and is reprinted at App. 44a. The decision of the Administrative Law Judge is unreported and is reprinted at App. 68a. Opinions of the Chancery Division entered in the course of the litigation are unreported and are reprinted at App. 113a, 120a, and 123a.

JURISDICTION

The Appellate Division of the Superior Court of New Jersey entered its judgment on May 12, 1995. App. 1a. A timely petition for certification was denied by the New Jersey Supreme Court by order filed on September 27, 1995. App. 43a. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257.

PERTINENT CONSTITUTIONAL AND STATUTORY PROVISIONS

The Takings Clause of the Fifth Amendment and the Due Process Clause of the Fourteenth Amendment to the United States Constitution, and pertinent sections of the Fair Automobile Insurance Reform Act, L. 1990, c. 8, N.J.S.A. 17:33B-1 *et seq.*, 17:30A, are set forth at App. 124a-136a.

INTRODUCTION

This case presents, with stark clarity, a recurring issue of great importance on which the lower courts are in disagreement: whether a regulator denies a regulated firm the constitutionally-mandated fair rate of return when the regulator's actions prevent the firm from recovering its reasonable cost of capital. New Jersey, like nearly every other state, regulates the rates that automobile insurance companies may charge. In this case, New Jersey, again like several other states, enacted an insurance "reform" measure that imposed substantial financial burdens on automobile insurers, including petitioner State Farm. Specifically, New Jersey required insurers to pay large surtaxes and assessments—$41 million in State Farm's case just during the two years at issue in this litigation—to bail out the state's debt-ridden association for insuring high-risk drivers.

Rather than allowing insurance companies to treat these surtaxes and assessments like other costs, which are reflected in the rates insurers are permitted to charge, New Jersey relegated State Farm to an after-the-fact proceeding

at which State Farm was required to prove that its returns had been inadequate. When State Farm *did* prove that its returns were inadequate—falling well below the level that even the court below conceded was the "fair rate of return" and the "cost of capital"—New Jersey simply changed the rules of the game: the court below decided that in a "retrospective" proceeding, held not to set rates for the future but to determine whether there has been confiscation in the past, a firm's reasonable cost of capital—the standard established by a half-century of this Court's decisions—should no longer be the constitutional minimum. Instead the court below, on its own initiative, looked to the annual nationwide industry average return—an analytically flawed standard with no support in the decisions of this or any other court.

The course New Jersey followed here—insurance "reform" consisting of monetary exactions, followed by an after-the-fact conclusion that the insurer has actually received adequate returns—has been used by other states in the past, and will be used again. It is a particularly dangerous combination. Retrospective proceedings to determine whether there has been an inadequate rate of return are rife with possibilities for manipulation. Determining the actual returns of a firm is a complex process, in which the regulator's findings of fact and judgments on technical questions receive great deference. Determining the cost of capital can also be complicated, and the regulators again receive great deference.

The decision below, however, is distinctive in its clarity. The court frankly acknowledged that State Farm's returns fell below the cost of capital; that the state's exactions were the *only* reason they did so; and that the state's action could be upheld only if the cost of capital standard were abandoned. For this reason, this case squarely presents the issue that, in other instances, will typically be buried in a welter of technical considerations: whether the cost of capital standard established in this Court's decisions remains the governing constitutional

principle. This case accordingly provides a signal opportunity for the Court to ensure that an increasingly popular governmental action—insurance "reform," generated by political pressure and designed to reduce rates—be conducted according to the proper constitutional standards.

STATEMENT OF THE CASE

1. *The Reform Act.* New Jersey, like nearly every state in the Nation, regulates the premiums that may be charged for private passenger automobile insurance. For some time, New Jersey has faced what its own Supreme Court characterized as "an intractable problem of providing coverage for high-risk drivers." *State Farm Mut. Auto. Ins. Co.* v. *State*, 124 N.J. 32, 40, 590 A.2d 191, 195 (1991). New Jersey responded to this problem in 1983 by establishing an agency commonly known as the Joint Underwriting Association ("JUA") to provide insurance to high-risk drivers. Because the JUA was forbidden to charge rates higher than those set in the voluntary market, "it was anticipated that [the JUA's] premium revenues would not cover costs of claims against JUA policies." *Id.* at 41, 590 A.2d at 196. Although the JUA had other sources of income, including surcharges on the premiums paid by voluntarily insured drivers, it not surprisingly incurred increasingly large deficits. By 1990, the JUA had accumulated a deficit of over $3.3 billion. *Id.* at 41-42, 590 A.2d at 195-196.

Following a gubernatorial campaign in which the cost of automobile insurance was one of the leading issues,[1] New Jersey, in 1990, adopted the Fair Automobile Insurance Reform Act, N.J.S.A. 17:33B-1 *et seq.* ("Reform Act"). The Reform Act provided, among other things, that the JUA deficit would be paid off in large part

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[1] As a candidate, Governor Florio promised to abolish the JUA, reduce rates by 20 percent, and "send the JUA bill where it belongs: to the insurance companies." Appellant's App. at 290a, *State Farm* v. *State*, 124 N.J. 32, 590 A.2d 191.

through surtaxes and assessments imposed on all firms licensed to write automobile insurance in the state.[2] The Reform Act also provided explicitly that the surtaxes and assessments—more than double the operating profit allowed under New Jersey law—could not be passed through into the premiums that insurance companies charged their New Jersey customers. N.J.S.A. 17:33B-51; N.J.S.A. 17:30A-16(b); *State Farm* v. *State*, 124 N.J. at 45, 590 A.2d at 197. Indeed, when the Reform Act was introduced, the New Jersey Governor pledged that "[t]here would be no pass through to consumers of any assessment or premium tax." Appellant's App. in Appellate Div., at 473.

Several insurance companies, in a case that preceded this one, challenged the Reform Act on its face as a violation of the Takings Clause of the United States Constitution. The New Jersey Supreme Court rejected the challenge. The court highlighted one section of the Reform Act which acknowledged that insurers are entitled to a rate of return that satisfies the constitutional minimum. Relying on that section and procedures established by the Commissioner of Insurance that would allow insurers to apply for adjustments in their rates to secure the constitutional minimum, the court concluded that it could "[]not now say that * * * the Reform Act would make it *impossible* for *any* insurer to achieve a fair rate of return." *State Farm* v. *State*, 124 N.J. at 61, 590 A.2d at 206 (emphasis added). The court stated that the proper way for an insurer to raise the constitutional issue was to apply to the Commissioner of Insurance for an adjustment; after the Commissioner acted, if the firm believed that imposition of the surtaxes and assessments

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[2] The Reform Act imposed a 5% premium surtax on all private passenger automobile insurers for the years 1990 to 1992, N.J.S.A. 17:33B-49(a), and also imposed assessments on all property and casualty insurers to raise an additional $160 million each year from 1990 to 1997. N.J.S.A. 17:30A-8(a)(9), (10). The assessment was 2.7% and 2.6% of all property and casualty premiums in 1990 and 1991, respectively.

caused its returns to fall below the constitutional minimum, it could then claim that the Reform Act was unconstitutional as applied. *Id.* at 63, 590 A.2d at 207.

Although the state supreme court ruled that these proceedings before the Commissioner (and any subsequent court challenge) were the only way for an insurance company to challenge the constitutionality of the surtaxes and assessments, the court felt constrained to "acknowledge uncertainty about how the Act may be applied by the Commissioner in individual rate-increase determinations" and to admit that "the rate application process * * * by its very complexity may carry the potential for frustrating in practice the achievement of a fair rate of return." *Id.* at 62, 590 A.2d at 207. Justice Garabaldi, in a special concurrence, went even further, saying: "I have grave doubts about the ability of the Commissioner of Insurance * * * to guarantee insurance companies a constitutionally-adequate rate of return." *Id.* at 66, 590 A.2d at 209.

2. *The Administrative Proceedings Below.* State Farm pursued just the course specified by the state supreme court, through long and tortuous proceedings. First, State Farm applied to the Commissioner for adjustments to its rates that would reflect the surtaxes and assessments. The Administrative Law Judge ("ALJ") assigned to the case refused to consider State Farm's request to adjust its future rates to account for the taxes it had already paid, adopting the Department of Insurance position that this would "constitute[] impermissible retroactive ratemaking." Appellant's App. in Appellate Div., at 146. *See* App. 116a. State Farm sought judicial review, and a Chancery Judge overturned the ALJ's action, declaring it "inexplicable." *Id.* at 117a. He remanded the matter to the ALJ with instructions to answer the specific questions necessary to decide State Farm's claim: what State Farm's rates of return were in 1990 and 1991, both with and without the challenged surtaxes and assessments, and

what the fair rate of return was for those years. *Id.* at 117a-119a.

On remand, the ALJ concluded that the fair rate of return for the period in question was approximately 13%, and that State Farm's earnings were 3.4% for 1990 and 7.5% for 1991 after consideration of the surtaxes and assessments. *Id.* at 91a, 102a. The ALJ nonetheless denied relief. He did so by invoking a statistical device known as a "confidence interval"—a device whose use was subsequently repudiated by the court below (*see id.* at 31a-32a)—concluding that rates as low as *negative* 3.6% would satisfy the constitutional standard. *Id.* at 92a. The Commissioner of Insurance adopted this conclusion and upheld the denial of relief. *Id.* at 44a.

3. *The Decision Below: the Takings Clause Issue.* The court below, reviewing the Commissioner's decision, upheld the ALJ's findings that State Farm's achieved rate of return was 3.4% in 1990 and 7.5% in 1991. App. 3a. The court below also accepted the ALJ's and Commissioner's conclusion that the "fair rate of return" for those years was 13%. *Id.* at 10a-11a. Notably, the court explicitly equated "the fair rate of return" to "the cost of capital": "[T]he fair rate of return in a prospective proceeding is one needed to attract investors, often called by the experts the cost of capital." *Id.* at 9a.

The court below did not disturb the ALJ's conclusion that without the surtaxes and assessments, State Farm's returns would have covered its cost of capital, or nearly so: 12.7% in 1990 and 16.4% in 1991. *Id.* at 12a. The court below also noted that State Farm had demonstrated that "it experienced no unusual casualties or other factors which reduced its rate of return" and that even the state's experts "all conceded that they could find nothing in State Farm's experience in New Jersey, *other than the surtaxes and assessments,* which would produce the low rate of return." *Id.* at 31a (emphasis added). The court pointed out that nothing in the ALJ's findings supported the con-

clusion "that State Farm's rate of return was caused by factors other than the surtaxes and assessments." *Id.* at 31a.

The court below nonetheless balked at the apparent conclusion of this syllogism—that if the state's imposition of nonrecoverable surtaxes and assessments forces a firm's returns below the cost of capital, the state has violated the Takings Clause. The court rejected this conclusion on the ground that the "cost of capital" standard "is a prospective concept." App. 9a. In this case, the court explained, it was not establishing rates for the future but deciding whether there had been confiscatorily low rates in the past. Accordingly, the court insisted, the appropriate standard was not the reasonable cost of capital but the nationwide industry average return—4.8% for 1990. "The 'takings' clause requires no remedy where the effect of price regulation has been to reduce actual return to the industry average." *Id.* at 23a. It was a "misconception[]," the court said, to believe that the cost of capital standard applies "in a retrospective proceeding" or "is the minimally acceptable rate of return." *Id.* at 24a.

4. *The Decision Below: the Due Process Issue.* The court below also rejected State Farm's argument that the after-the-fact remedy afforded to it was not "clear and certain" and thereby violated the Due Process Clause, as interpreted by this Court in *McKesson Corp.* v. *Division of Alcoholic Beverages*, 496 U.S. 18 (1990). The court below admitted that the procedures established by the Commissioner to consider State Farm's claims did not provide "meaningful standards." App. 40a. The court below also recognized that the Commissioner's regulations did not even specify standards for determining the two key components in any rate regulation confiscation case: (1) "what constituted a 'constitutionally adequate return' " and (2) "how the Commissioner proposed to compute the achieved return." *Id.* at 32a.

In fact, the absence of advance standards on these key points allowed the Commissioner to devise an ad hoc approach calculated to deny State Farm any relief. Thus, rather than follow the established procedure in New Jersey law for calculating an insurer's operating results in a retrospective proceeding (*see* note 5, *infra*), the Commissioner picked and chose among various expense and income items, with "some inconsistencies," to arrive at an achieved rate of return calculation that "did make it difficult for insurers generally to succeed" in their constitutional challenges. *Id.* at 41a. While the court below repudiated the bizarre "confidence interval" theory for determining the constitutionally adequate rate of return, it also came up with a novel approach of its own with its invocation of the nationwide industry average standard. *Id.* at 3a. Despite the fact that these key standards were settled on only after the fact—when it was clear they would lead to a denial of relief—the court concluded summarily that State Farm "received fair treatment and achieved a fair rate of return." *Id.* at 40a.

The New Jersey Supreme Court denied a timely petition for certification. App. 43a.

REASONS FOR GRANTING THE WRIT

I. THE COURT BELOW, IN CONFLICT WITH DECISIONS OF THIS COURT AND SEVERAL LOWER COURTS, REJECTED THE PRINCIPLE THAT A REGULATED FIRM IS ENTITLED TO AN OPPORTUNITY TO RECOVER ITS COST OF CAPITAL

The court below rejected the principle that, under the Takings Clause of the Fifth Amendment, a regulated firm is entitled to an opportunity to recover the cost of its capital and reasonable expenses. This ruling is irreconcilable with this Court's decisions and in conflict with decisions of several other lower courts.

A. This Court's Decisions Establish That The Cost Of Capital Standard Applies When A State Regulates The Rates A Firm May Charge

1. As the Court has recently reiterated, a firm whose prices are regulated by the government is protected, by the Constitution, against having its rates set too low. "If the rate does not afford sufficient compensation, the State has taken the use of [the regulated firm's] property without paying just compensation and so violated the Fifth and Fourteenth Amendments." *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989). Calculating the precise rate that a firm should receive can, of course, be a dauntingly technical task. But this Court's opinions, for the last 50 years or more, have made at least one point clear: "sufficient compensation" means "enough revenue not only for operating expenses but also for the capital costs of the business." *Federal Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). "These include service on the debt and dividends on the stock." *Id.* A regulated firm's return, the Court explained in *Hope*, must be "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id.*

The reason that a firm is entitled to recover its cost of capital is not technical or esoteric: it is simply that, from the point of view of the Takings Clause, there is no distinction between a firm's operating costs and the cost of its capital. Investors who have not received a fair return on their investment because of state regulation have had their property "taken" just as surely as if they were denied the opportunity to recover operating expenses paid out of their pockets. Justice Brandeis explained this point in the opinion that—as this Court has noted (*see Duquesne Light*, 488 U.S. at 309)—laid the conceptual foundation for *Hope*: "[T]here is no difference between the capital charge and operating expenses * * *. Each is part of the current cost of supplying the service; and each should be

met from current income." *Southwestern Bell Tel. Co. v. Public Serv. Comm'n,* 262 U.S. 276, 306 (1923) (concurring opinion).

Justice Brandeis could not have been more explicit in stating that the right to recover the cost of capital is a constitutional *guarantee*:

> The thing devoted by the investor * * * is not specific property * * * but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the [regulated firm] the opportunity to earn a fair return. Thus, it sets the limit to the power of the State to regulate rates.
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> * * * *
>
> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance * * * for the use of the capital[;] the allowance for risk incurred; and enough more to attract capital. [*Id.* at 290-291 (footnote omitted).]

Since *Hope,* the Court has held fast to this principle. In *Permian Basin Area Rate Cases,* 390 U.S. 747, 792 (1968), the Court emphasized that a court reviewing a rate order "must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed." In *Duquesne Light,* the Court rejected a claim that rates were confiscatory precisely on the ground that they covered the reasonable cost of capital:

> No argument has been made that these * * * rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for

> the risk associated with their investments. [488 U.S. at 312 (footnote omitted).]

2. The issue in any case in which there is a claim that rate regulation has resulted in a taking is the end result of the state's actions. *See Duquesne Light*, 488 U.S. at 310 (" '[I]t is * * * the impact of the rate order which counts.' ") (quoting *Hope*, 320 U.S. at 602). The court below concluded that State Farm's "fair rate of return" —explicitly equated to the "cost of capital"—was 13% for the years in question. It nonetheless ruled that the Constitution permitted New Jersey—through the Reform Act's nonrecoverable surtaxes and assessments—to drive State Farm's returns far below that. The inconsistency between the decision below and the governing standards of this Court could not be more clear. Indeed, the court below was able to reach the result it did only by brushing aside the *Hope* cost of capital standard, declaring it a "misconception[]" to suppose that the cost of capital "is the minimally acceptable rate of return." App. 24a.[3]

Ordinarily, ratemaking cases present complex issues concerning such relatively technical matters as the actual rate of return, the reasonableness of various expenses, the rate base, and the reasonable return on the rate base. This case presents none of those factual complexities. It instead starkly poses the legal question whether a state may reduce a regulated firm's return below the cost of capital.

3. The decision below, not surprisingly, also conflicts with many decisions in the lower courts that have recognized the cost of capital standard. As we discuss in

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[3] If a regulated industry is in decline for market-related reasons unconnected to price regulation and firms in the industry "could not attract capital on any possible rate," the cost of capital standard may not apply. *Market Street Ry.* v. *Railroad Comm'n*, 324 U.S. 548, 566 (1945). Neither New Jersey nor the court below ever suggested that comparable circumstances account for the ruling in this case, and no such suggestion would be plausible.

Point III, there has been some significant erosion of the cost of capital standard in the lower courts, and the New Jersey court's decision in this case is sure to accelerate that problematic trend. But for the most part the lower courts have adhered to the cost of capital standard.

For example, as Justice Souter explained for the New Hampshire Supreme Court, "[a]t a minimum, the return must equal the cost of capital * * * [which] is the cost of borrowing money and the cost of attracting equity investment." *Appeal of Cheshire Bridge Corp.*, 126 N.H. 425, 493 A.2d 1151, 1156 (1985). Justice Souter went on to say: "[O]nce the cost of capital has been determined * * * it marks the minimum rate of return to which the company is lawfully entitled." *Id.* at 1157 (internal quotation marks omitted). *See also Public Service Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269, 271 (1988) (Souter, J.) ("[A] utility's threshold entitlement is to a rate of return equal to the cost of capital.").

Many courts of appeal agree. *See, e.g., Boston Edison Co.* v. *FERC*, 885 F.2d 962, 964-965 (1st Cir. 1989) (Breyer, J.); *Distrigas of Mass. Corp.* v. *FERC*, 737 F.2d 1208, 1211 (1st Cir. 1984) (Breyer, J.); *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508, 515 (9th Cir. 1990). As the District of Columbia Circuit—which has perhaps the most extensive experience with rate regulation among the federal courts of appeals—explained:

> Regulated industries are entitled to earn enough revenue not only to cover operating expenses but also to pay for the capital costs of doing business, including service on debt and dividends on stock. The return to the equity owner must be "sufficient to assure confidence in the financial integrity of the enterprise," * * * in order that its credit may be maintained and capital may continue to be attracted. [*United States* v. *FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983), citing *Hope*, 320 U.S. at 603.]

See Tennessee Gas Pipeline Co. v. *FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("investors must be allowed an opportunity to earn returns sufficient to 'attract capital' * * * and 'to compensate [the] investors for the risks assumed' ") (quoting *Hope*, 320 U.S. at 605); *AT&T* v. *FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988) ("The rate of return * * * must be sufficient to cover the cost of capital the carrier must raise to do business").[4]

B. The Retrospective Nature Of A Proceeding Does Not Justify A Departure From The Cost Of Capital Standard, And The Alternative Standard Adopted By The Court Below Is Unfounded And Invites Abuse

1. The court below explained its conclusion by asserting that a firm is entitled to recover its cost of capital only in a "prospective" proceeding, not in a retrospective

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[4] *See also, e.g.*, *Alabama Power Co.* v. *Alabama Pub. Serv. Comm'n*, 422 So. 2d 767, 770 (Ala. 1982) ("constitutionally mandated fair rate of return * * * involves cost of debt capital, cost of preferred stock, and cost of equity capital"); *Central Maine Power Co.* v. *Public Utils. Comm'n*, 153 Me. 228, 136 A.2d 726, 740 (1957) ("It is repeatedly stated or implied in the decided cases, so far as we know without contradiction, that one of the constitutional rights of a regulated utility is the right to earn a sufficient return to maintain its credit and to obtain additional capital when needed to enable it to serve its public") (quoting *New England Tel. & Tel. Co.* v. *Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509, 516 (1951)); *Attorney General* v. *Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72, 75 (1984) ("In general, the return on equity must equal at least the amount which the company would have to pay in order to 'hire' its equity capital under current conditions") (citations omitted); *Mountain States Tel. & Tel. Co.* v. *Department of Pub. Serv. Regulation*, 191 Mont. 331, 624 P.2d 481, 482 (1981) ("In determining a fair and reasonable rate of return, it is necessary to determine what it costs the utility to secure the required capital to finance its operations"); *Hastings* v. *Village of Stowe*, 125 Vt. 227, 214 A.2d 56, 61 (1965) ("the rate of return must be sufficient to provide enough revenue for capital costs of the business, including service on the debt and dividends on the stock").

proceeding. But this distinction is illogical on its face. A regulated firm is entitled to its cost of capital for the reason given 70 years ago by Justice Brandeis and repeatedly reaffirmed by this Court: that otherwise investors have had property taken from them. An investment on which they could have earned a 13% return elsewhere, at comparable risk, yielded only 3.4%, not because of market conditions but because of government fiat. This common sense definition of a taking applies regardless of when a state elects to provide a regulated firm the constitutionally mandated opportunity to present its takings claim; it does not cease being true when a regulator suppresses rates at the outset and forces the regulated firm to prove inadequate returns in a retrospective proceeding.

In retrospective hearings, of course, more is known about a firm's actual performance. Regulators need not rely on projections and extrapolations about the firm's costs and revenues, as they must in setting rates for the future. On the other hand, the fact that a firm has a low or even negative return in a certain period does not mean that its rates were set unconstitutionally low. The constitutional guarantee is of an *opportunity* to earn the cost of capital plus operating expenses. Low returns for a particular period may be the result of poor management, a catastrophe, or adverse market conditions; if they are, then the firm is of course entitled to no relief.

In this case, it was not difficult to determine whether State Farm's poor bottom line was the result of market conditions or of government intervention. The effect of the surtaxes and assessments was so dramatic that even the expert witnesses supporting the state, not to mention the court below, had to admit—and did admit—that State Farm's shortfall resulted from the state's actions. *See* App. 31a. Thus, in this case, the retrospective nature of the proceeding simply allowed State Farm to show with certainty that it was subjected to confiscatory rate regulation.

The court below referred repeatedly to the "novelty" of a retrospective hearing.[5] But the novelty of a procedure does not justify abandoning established constitutional standards. The retrospective hearing was the result, of course, not of State Farm's actions, but of the state's refusal to allow the surtaxes and assessments to be treated like other expenses and built into the rates prospectively. In fact, around the Nation, proceedings of this kind are less novel than they once were, and are destined to become less novel still—should this Court not intervene here—as other states adopt the techniques that have effectively allowed New Jersey to take $41 million of State Farm's property. The court below explicitly relied on a recent decision of the California Supreme Court that also refused to adhere to the cost of capital standard in a retrospective proceeding. *20th Century Ins. Co.* v. *Garamendi*, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994), *cert. dismissed*, 115 S. Ct. 1085 (1995), *cert. denied*, 115 S. Ct. 1106 (1995). The court below called this aspect of the California Supreme Court's opinion "soundly reasoned." App. 28a.

2. Having jettisoned the *Hope* cost of capital standard, the court below was compelled to devise a new constitutional touchstone. It settled on the "nationwide industry average" return, even though no party ever advocated or

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[5] In fact retrospective reviews of profitability are, in an important sense, not novel under the New Jersey regulatory regime. New Jersey has the country's most stringent excess profits law capping insurer profits, N.J.S.A. 17:29A-5.6 *et seq.*, and that law requires insurers to compute retrospectively the revenue and expenses from their insurance operations and to rebate to policyholders any "excess" operating profit. State Farm vigorously (but unsuccessfully) argued below that this proceeding should be treated just like other after-the-fact determinations of an insurer's returns already regularly undertaken by New Jersey. If the state had followed its own established excess profits methodology in this case, State Farm's returns would have been negative 4.6% in 1990 and 1.2% in 1991, even more clearly confirming that State Farm is entitled to relief on its confiscation claim. *See* Pet. for Certification at 5-6.

even mentioned such a standard. The "nationwide industry average" standard is analytically unsustainable, and the court below failed to cite a single case from any court—let alone from this Court—to support it. More important, however, the use of a standard of this kind in a retrospective proceeding opens the door for violations of a regulated firm's rights under the Takings Clause.

The nationwide industry average return standard exposes a regulated entity's assets to seizure in any year in which the industry, as a whole, had poor earnings. Those assets would be at risk regardless of the individual company's earnings, or the factors that distinguished that company from the industry as a whole. The standard is affected by factors that have no bearing on State Farm's conduct of its insurance business in New Jersey. In any one year, there can be sharp regional variations in the claims experience of insurance companies; earthquakes, hurricanes, or economic conditions in other parts of the country should not reduce the returns insurers are allowed in New Jersey.[6] Poor performance by some insurance firms can depress the nationwide industry average return; it is perverse to use that as a reason to force lower rates on well-managed firms.

Finally, of course, the nationwide industry average is affected by the decisions of regulators. If regulators in California suppress rates, the industry average standard allows regulators in New Jersey to do likewise, and vice versa. It is circular, and absurd, to adopt a standard that allows this to happen. These are the reasons that this Court has never suggested, much less adopted, the nationwide average standard.

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[6] Automobile insurance is counter-cyclical; returns decline in periods of economic growth, because people drive more and therefore have more accidents. Economic conditions often vary greatly from region to region, so the nationwide average return will be affected by conditions that have nothing to do with the environment in which a particular firm is operating.

The *Hope* cost of capital standard is different. Although not a mathematically precise number, it is a well-established concept in this Court's decisions, far less subject to manipulation by the very governmental authorities the Takings Clause was intended to constrain. Once that constitutional floor is abandoned, the regulated entity's right to be free of confiscatory rates is at the mercy of a standardless and ever changing target. Here, the court below selected the 4.8% return figure from among no fewer than 45 different assertedly applicable historic returns in the record, ranging from 1.6% to 20.7%.[7] The constitutional protection against confiscatory rates is meaningless if the cost of capital standard is abandoned and government is allowed to pick and choose among a wide array of historic returns, settling upon not a standard at all but a rate that is like "a restricted railroad ticket, good for this day and train only." *Smith* v. *Allwright*, 321 U.S. 649, 669 (1944) (Roberts, J., dissenting). *See Duquesne Light*, 488 U.S. at 315.

The constitutional infirmity of this approach is heightened when this *ad hoc* selection of a "standard" takes place in a retrospective inquiry. At that point a regulated firm can do nothing to increase revenues or decrease expenses to improve its returns, nor can the firm elect to withdraw from the regulated business. The returns are already in and the regulator—if not constrained by a previously adopted, objective standard—can choose the rules that will lead to the desired result. Such an approach makes no sense under the Takings Clause, which was after all designed to bridle government officials, to prevent

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[7] Although the court below looked to the California Supreme Court's decision in *20th Century* for support, App. 3a, 26a-28a, that case involved a different standard—a *10-year* industrywide historic return yielding a 10% rate of return. 8 Cal. 4th at 302, 878 P.2d at 621, 32 Cal. Rptr. 2d at 862. If the court below had picked that standard, State Farm would have been entitled to significant relief on the undisputed facts. The point is that once the cost of capital standard is abandoned, there is no meaningful objective standard to take its place.

them from doing exactly what New Jersey did here—take private property for public use, without just compensation.

II. NEW JERSEY'S FAILURE TO PROVIDE A CLEAR AND CERTAIN REMEDY, PURSUANT TO A CONSISTENT STANDARD, VIOLATED THE DUE PROCESS CLAUSE

The court below rejected State Farm's argument that the administrative procedures established by the Commissioner violated the Due Process Clause because they provided no "clear and certain" remedy. *See McKesson Corp.* v. *Division of Alcoholic Beverages*, 496 U.S. 18, 39, 51 (1990). Under the state supreme court's earlier decision, those procedures provided the sole remedy for an insurance carrier who claimed that the surtaxes and assessments were confiscatory. State Farm asserted that the criteria used in these remedial proceedings were so shifting and vague that they could not be said to be clear and certain.

The court below essentially agreed with State Farm's description of the procedures that were afforded to it. The court said: "We do not think the Commissioner has provided meaningful standards" to guide the determination whether an insurer was subjected to confiscatory rates. App. 40a. The court acknowledged that "the regulations did not specify precisely what constituted a 'constitutionally adequate return' nor did they inform insurers how the Commissioner proposed to compute the achieved return." *Id.* at 32a. But the court nonetheless denied relief, concluding that State Farm "received fair treatment and achieved a fair rate of return." *Id.* at 40a.

State Farm's Due Process Clause argument cannot be answered, however, by a conclusory assertion that it has been treated fairly. The Reform Act imposed an enormous tax on State Farm, which State Farm promptly challenged on constitutional grounds. The state supreme court ruled that State Farm had to pay the tax and could

raise its constitutional claim only in after-the-fact proceedings. This is just the factual pattern of *McKesson*, and in these circumstances the law is clear:

> When a State penalizes taxpayers for failure to remit their taxes in timely fashion, thus requiring them to pay first before obtaining review of the tax's validity, federal due process principles long recognized by our cases require the State's postdeprivation procedure to provide a "clear and certain remedy." [*McKesson*, 496 U.S. at 51, quoting *Atchison, T. & S.F.Ry.* v. *O'Connor*, 223 U.S. 280, 285 (1912).]

The court below admitted that the remedy afforded to State Farm was anything but "clear and certain"; it follows that State Farm is entitled to relief.

This point is not an abstract one, and its importance extends beyond this case. The state's failure to provide a clear remedy significantly prejudiced State Farm. As the court below conceded, the Commissioner never specified the standard that he would apply in determining whether an insurer had received a constitutionally adequate return. That standard shifted throughout this proceeding. The Commissioner, after failing to specify any standard in his regulations, adopted a wildly novel "confidence interval" approach and took the position that a negative rate of return could be adequate—a course that even the court below was obliged to repudiate. *See* App. 28a-32a. The "nationwide industry average" standard on which the court below relied made its first appearance in the opinion below—it had not been urged by the Commissioner or even any of the expert witnesses (and, as we have said, had never been suggested by this Court nor, so far as we are aware, any other court). In a word, the state did precisely what this Court held, just last Term, to violate *McKesson*—it "reconfigure[d] its scheme, unfairly, in *midcourse*." *Reich* v. *Collins*, 115 S. Ct. 547, 550 (1994) (emphasis in original). The process afforded State Farm was like playing a game first and then being

told the rules—by your opponent. *See* App. 41a ("the Commissioner did make it difficult for insurers generally to succeed in an as-applied challenge").

As it happens, State Farm did not, in fact, receive the nationwide industry average return. State Farm's return in 1990, according to the ALJ and the court below, was 3.4%; the nationwide average was 4.8%. In 1991, State Farm's return was found to be 7.5%; the nationwide average was 10.6%.[8] But State Farm never had an opportunity to make this argument—the 4.8% "standard" was not contested in the administrative proceedings, and the 10.6% figure was not even in the record—because the state never suggested, until the court below filed its opinion, that the nationwide industry average was the applicable standard.[9]

McKesson requires that a postdeprivation remedy be not only "clear and certain" but also "fully adequate." 496 U.S. at 41. A state may relegate a taxpayer to a postdeprivation remedy for illegally collected taxes, but only if the state's postdeprivation remedy affords the same substantive constitutional protection to which the taxpayer would be entitled in the predeprivation remedy the state otherwise would have to provide. *See, e.g., McKesson*, 496 U.S. at 43 (postdeprivation remedy for discriminatory taxation in violation of the Commerce Clause must "bring about the nondiscrimination that 'prompt injunctive relief would have achieved' ") (emphasis omitted; quoting respondents' brief on reargument). If, for example, the taxpayer's claim would have blocked the collection of any taxes had it been heard prior to their collection, the postdeprivation remedy must provide for a full refund.

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[8] *See* Pet. for Certification at 13 n.8, Pa 135.

[9] State Farm did raise its right to relief even under the nationwide industry average standard at its first available opportunity, in its petition for certification before the New Jersey Supreme Court. Pet. for Certification at 13 n.8. *See Brinkerhoff-Faris Trust & Sav. Co.* v. *Hill*, 281 U.S. 673, 677-678 (1930); *PruneYard Shopping Center* v. *Robins*, 447 U.S. 74, 85-86 n.9 (1980).

See, e.g., O'Connor, 223 U.S. at 285-286; *Iowa-Des Moines Nat'l Bank* v. *Bennett,* 284 U.S. 239, 247 (1931). A postdeprivation remedy that authorized a refund of only 50 percent of illegally collected taxes would plainly not satisfy the "*McKesson* line of cases." *Reich* v. *Collins,* 115 S. Ct. at 551.

Yet that is precisely the result of the decision below. The court below recognized that, in a prospective proceeding, State Farm would be entitled to a rate of return reflecting the reasonable cost of capital—13%. New Jersey, however, denied State Farm the opportunity to press its claim in a prospective proceeding, relegating it to a retrospective remedy. *State Farm* v. *State,* 124 N.J. at 63, 590 A.2d at 207. But then the court below held that in that retrospective proceeding, State Farm was entitled to a rate of return of only 4.8%—less than *half* the return it would have been entitled to for the *same* period had the issue been addressed in a prospective proceeding. Such a postdeprivation remedy subjecting the claimant to a materially harsher constitutional standard does not "satisfy the Due Process Clause's requirement of a fully adequate postdeprivation procedure." *McKesson,* 496 U.S. at 41.

This issue has important ramifications beyond what has happened in this case because, as we have said, there is a great danger of abuse in retrospective rate regulation proceedings. This is especially true when the fact that the proceeding is retrospective is held to free regulators from the *Hope* cost of capital standard; but the danger is further heightened when regulators are also allowed to shift standards back and forth and select among them smorgasbord-style until they find the combination that (lo and behold) leads to a denial of relief. Because, as we have said (and as we discuss further below), regulators in many states will be under pressure to resort to devices like this, the Court should grant review to make clear the application of *McKesson* in this setting.

III. THE DECISION BELOW REFLECTS A RECURRING PATTERN THAT WARRANTS THIS COURT'S INTERVENTION

Unfortunately the events in New Jersey do not represent an isolated development. As we have said, many lower courts do continue to adhere faithfully to the cost of capital standard. *See* pages 13-14 above. But other states have done, or attempted to do, what New Jersey has done, and more can be expected to do so if the Court does not intervene.

It is not likely, however, that there will be another decision as clear as this one in spelling out just what has occurred. In this case the lower court's rejection of the cost of capital standard is fully explicit and unencumbered by technical regulatory issues. This is, therefore, a singularly appropriate occasion for the Court to grant review.

Even before New Jersey adopted its Reform Act, California, by popular initiative, adopted an insurance "rollback" measure. California insurers were ordered to reduce their rates, while review of the insurers' constitutional confiscation claim was postponed to retrospective proceedings. The state supreme court upheld the denial of that claim in those proceedings by jettisoning the cost of capital standard in favor of, in that case, an open-ended balancing approach. *20th Century Ins. Co.* v. *Garamendi*, 8 Cal. 4th at 293-296, 878 P.2d at 615-616, 32 Cal. Rptr. 2d at 856-857.[10] Not surprisingly, the court

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[10] The contrast between *20th Century* and this case illustrates why review by this Court is especially appropriate here. In *20th Century*, the reasoning of the lower court was complex and obscure, and the lower court never specified just what standard it was adopting. Instead, it purported to adopt a "balancing" approach, thus leaving unclear exactly how it would review rate regulation in the future. By contrast, the lower court here made its reasoning plain: it boldly stated that it was abandoning the cost of capital standard, and gave as its reason the fact that this was a retrospective proceeding. That makes this a vastly more appropriate case

below, in seeking to justify its action, relied on the California Supreme Court's decision. App. 26a-28a.

Nevada sought to adopt a rollback similar to California's, but the Ninth Circuit turned the effort aside on the ground that the state scheme did not guarantee insurers an opportunity to earn "the constitutionally required 'fair and reasonable return,'" defined to include " 'enough revenue not only for operating expenses but also for the capital costs of the business.'" *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d at 515 (quoting *Hope*, 320 U.S. at 603). In the meantime, Pennsylvania and South Carolina adopted comparable measures. *See* 75 Pa. Cons. Stat. § 1799.7(b); S.C. Code Ann. § 38-73-465(D). Efforts to adopt such proposals are underway in several other states. The popularity of these measures is unlikely to abate.

At the same time, courts in several states have begun to drift away from the cost of capital standard. Often, as in California, they have adopted an open-ended "balancing" test in which the cost of capital is only one component. This is true, for example, of sharply divided state supreme courts in Ohio and Kansas. *See Ohio Edison Co.* v. *Public Utils. Comm'n*, 63 Ohio St. 3d 555, 589 N.E.2d 1292 (1992); *Kansas Gas & Elec. Co.* v. *State Corp. Comm'n*, 239 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 479 U.S. 1082, *app. dismissed*, 481 U.S. 1044 (1987). *See also Pennsylvania Elec. Co.* v. *Pennsylvania Pub. Util. Comm'n*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed for want of substantial*

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for review. Indeed it seems doubtful that the Court will see a ratemaking case with this degree of clarity at any time in the foreseeable future.

In addition, the court below explicitly followed the California ruling in crucial respects. California and New Jersey are, of course, two of the most populous states, with perhaps the most closely observed insurance markets in the Nation. Thus a nationwide pattern, justifying this Court's intervention, has become even more apparent since *20th Century*.

federal question, 476 U.S. 1137 (1986). Such a "balancing" approach necessarily obscures the issue and makes it difficult to review the lower courts' decisions. By contrast, the New Jersey court made no feint at balancing; it was fully explicit in its rejection of the cost of capital standard. The cost of capital was not described as simply one component in a multi-factored balancing test; it was expressly rejected in favor of a new and entirely unprecedented standard. This Court is, therefore, unlikely ever to have a better vehicle for dispelling the confusion that exists in the lower courts and for ensuring that future legislative action in this area conforms to proper constitutional standards.

CONCLUSION

For the foregoing reasons, this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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APPENDICES

APPENDIX A

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION

A-2042-92T5

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
Plaintiff-Appellant,

v.

THE STATE OF NEW JERSEY; SAMUEL FORTUNATO, Commissioner of Insurance of the State of New Jersey; EDWARD J. DAUBER, Acting Attorney General of the State of New Jersey; SAMUEL CRANE, Treasurer of the State of New Jersey; MARSHALL SELIKOFF, as Trustee of the New Jersey Full Insurance Underwriting Association,
Defendants-Respondents.

and

PROPERTY LIABILITY INSURANCE GUARANTY ASSOCIATION,
Defendant.

Argued: March 22, 1995—Decided: May 12, 1995

Before Judges King, Muir, Jr. and D'Annunzio.

On appeal from the Superior Court of New Jersey, Chancery Division, Mercer County.

The opinion of the court was delivered by KING, P.J.A.D.

I

This case involves an "as-applied" challenge to the constitutionality of the Fair Automobile Insurance Reform Act, *L.* 1990, *c.* 8 (Fair Act or Act), which compels property and casualty insurers to pay a 5% surtax on automobile insurance premiums for 1990 through 1992 and a 2.7% assessment on all property casualty premiums from 1990 through 1997. These charges were designed to aid in eliminating the deficit accumulated by the now-defunct New Jersey Automobile Full Insurance Underwriting Association, known as the JUA.

Appellant, State Farm Mutual Automobile Insurance Company (State Farm) previously claimed that the Fair Act was facially unconstitutional since it precluded insurers from recouping these surtaxes and assessments through ratemaking, depriving them of the constitutional right to the opportunity to realize a fair, reasonable return on investment. *State Farm v. State,* 124 *N.J.* 32 (1991) (*State Farm*). Relying on the section of the Fair Act stating that automobile insurers are entitled to earn an adequate rate of return through the rate-making process, our Supreme Court held that the "anti-pass through" provisions did not necessarily preclude all insurers from earning a fair rate of return. *Id.* at 62. The Court did hold that insurers were free to institute "as-applied" challenges, *id.* at 63, which is what State Farm has done here.

This case involves an unprecedented regulatory proceeding. Ratemaking is normally prospective. But here State Farm seeks relief from rates for the years 1990 and 1991. No claim was made for 1992. State Farm alleges that rates for those two years were too low and denied it a reasonable rate of return, mainly because of the 5% surtax and 2.7% assessment which totalled over $41 million for the two years.

None of the highly-qualified experts who testified at the administrative hearings were aware of any similar pro-

ceeding. These experts offered quite divergent views on (1) what constitutes a fair rate of return, and (2) the income and expenses properly considered in computing the achieved rate of return. After the hearings were concluded in this case, the California Supreme Court issued a lengthy opinion addressing the subject of a fair rate of return for insurers in a retrospective proceeding. *20th Century Ins. Co. v. Garamendi*, 878 *P.*2d 566, 632 (Cal. 1994).

We conclude from the record that State Farm has not shown an entitlement to monetary relief in the form of either a future tax credit, tax refund, higher future rates, or otherwise. Administrative Law Judge McGill (ALJ) decided that State Farm actually achieved a rate of return of 3.4% in 1990 and 7.5% in 1991, notwithstanding the surtaxes and assessments. This was a rate of return higher than realized by private-passenger automobile insurers nationally. We hold that the record supports this conclusion of the ALJ, which was adopted by the Commissioner of Insurance. We find that the rates actually realized by State Farm were not confiscatory because it obtained about the same return on the average as its competitors nationally, who were not subject to the surtaxes and assessments imposed by the Fair Act.

II

This is the relevant procedural history. This case is rooted in the Supreme Court's May 16, 1991 decision that State Farm did not establish that the Act was confiscatory on its face. 124 *N.J.* at 61-63. The Court presumed that the special rate-relief regulations adopted by the Commissioner, *N.J.A.C.* 11:3-16.11, would be administered to assure an insurer's constitutionally mandated fair rate of return. 124 *N.J.* at 62-63. Observing that successful challenges to the facial constitutionality of price control statutes are "exceedingly rare," *id.* at 46, the Court held that insurers remained free to mount an as-applied challenge should the Act, as administered, not

provide them with a fair rate of return. *Id.* at 62-63. The Court declared it "appropriate for the Commissioner to render determinations on individual insurers' rate-increase applications in the first instance, before challenges to the constitutionality of the application of the statute and regulations are brought" because the Department of Insurance (DOI) has the "particular expertise necessary" to develop a detailed record and to make findings on an as-applied challenge. *Id.* at 63.

State Farm had requested a rate increase on March 21, 1990, a few days after passage of the Act. Lengthy proceedings followed, but no hearing; State Farm and the Commissioner blamed each other for the delay. Shortly before the Court decided *State Farm*, appellant filed a notice of appeal with this court to have its application declared complete. On June 14, 1991 appellant and the DOI filed a stipulation of dismissal of the appeal and the matter was sent to the Office of Administrative Law (OAL).

A period for discovery ensued and a motion was made by DOI on October 8, 1991 to preclude State Farm from using any 1990 profit and loss data, on the theory that past losses were irrelevant to proceedings pending before the OAL. On January 2, 1992 ALJ McGill granted DOI's motion ruling that "any means by which a regulated company recovers an additional charge for past losses constitutes impermissible retroactive rate-making." Four weeks later, the ALJ scheduled hearings for late June and early July.

On May 19, 1992 State Farm, DOI and the Department of Public Advocate, Division of Rate Counsel (Rate Counsel), filed a stipulation dismissing State Farm's surtax and assessment filings, conditioned on and without prejudice to State Farm's right to bring an as-applied challenge. State Farm brought such a challenge on June 1, 1992, filing a complaint in the Chancery Division against the Commissioner, the Attorney General and

others. Count one alleged that State Farm had been deprived of substantive and procedural due process by DOI's delay in processing the application for higher rates and refusal to consider the surtax and assessment payments made in 1990 and 1991 in determining whether State Farm earned a fair and reasonable return in those two years. Count two alleged that DOI had deprived State Farm of its constitutional right to a fair return in 1990 and 1991, effectuating a taking of State Farm's property. Count three alleged a violation of State Farm's constitutional rights, claiming damages and relief under 42 *U.S.C.* § 1983. Appellant sought a refund of the 1990 and 1991 surtaxes and assessments or a credit against future payments; a declaration that the Commissioner's prior practices and rulings deprived State Farm of due process and just compensation; money damages, and attorneys fees, under 42 *U.S.C.* § 1988.

Judge Levy denied Rate Counsel's motion to intervene and we denied rate counsel's emergency motion to set aside that order. In an order dated August 6, 1992, he remanded the case to the OAL. In his opinion he found it "inexplicable" that DOI and the ALJ would not consider evidence of State Farm's profitability in 1990 and 1991, since without that evidence no one could compute State Farm's rate of return for those years. Relying on *State Farm, supra,* Judge Levy directed a hearing before the OAL to determine "what the insurer's rate of return was for 1990 and for 1991 and what a fair rate of return was for each of those years." If the achieved rate was not fair, then rates should be adjusted in a manner the Commissioner deemed reasonable. The judge also instructed the ALJ to take evidence and make findings on the reason for the delay in processing State Farm's application. Further review could be obtained either before this court or the Chancery Division, depending on the nature of the final action at the administrative level. On August 21, 1992 we denied the motion of the State defendants for leave to appeal, summary disposition and an

immediate stay of the order remanding the case to the OAL.

The OAL processed the case on an expedited basis, with ALJ McGill holding hearings on August 27 and 28 and September 1, 4, 15, and 16, 1992. The ALJ issued his initial decision on October 9, 1992. Substantially adopting Rate Counsel's methodology, he concluded that State Farm's achieved rate of return on its automobile business, even with payment of surtaxes and assessments; was 3.4% in 1990 and 7.5% in 1991. He found this return not only constitutionally adequate but at about the midpoint in the range of reasonableness and slightly higher on average "than the achieved rate of return of 4.8 percent for countrywide passenger automobile insurance." On the delay issue, the ALJ concluded that much of the delay was due to State Farm's resistance to discovery.

The Commissioner issued his final decision on November 17, 1992. He did not agree with all of the findings and conclusions of the ALJ, particularly some of the details in computing State Farm's actual rate of return for the years in question. He did agree with the ALJ that State Farm earned a fair and adequate return in 1990 and 1991, even with payment of the surtaxes and assessments. He also agreed with the ALJ's analysis of the reasons for the delay in processing State Farm's application. Judge Levy in the Chancery Division held that the Commissioner had issued a final decision and any further review must be in this court. He dismissed the Chancery Division complaint with prejudice on December 3, 1992.

State Farm filed this notice of appeal from the Commissioner's final order and from Judge Levy's December 3, 1992 order. On September 21, 1993 the Supreme Court denied State Farm's motion for direct certification.

III

State Farm is a mutual insurance company, authorized to sell automobile insurance, property and casualty insurance, and health insurance in New Jersey. Property-casualty lines other than private passenger automobile include homeowners, commercial, marine, fire, and workers compensation. About 75% of State Farm's total New Jersey property-casualty business is private passenger automobile insurance (PPA). State Farm is one of the major private passenger auto insurers in this State, ranking third in 1988, behind Allstate and Prudential, and ahead of New Jersey Manufacturers and Liberty Mutual.

Like all other automobile insurers, State Farm is subject to a 5% surtax on private passenger automobile premiums for the years 1990, 1991 and 1992. *N.J.S.A.* 17:33B-49; *State Farm, supra,* 124 *N.J.* at 44. State Farm also is subject to an assessment on all of its property-casualty lines, payable to the Property Liability Insurance Guaranty Association (PLIGA), an assessment which totaled 2.7% of net premiums in 1990. *N.J.S.A.* 17:30A-8a (9) & (10); *State Farm, supra,* 124 *N.J.* at 43-44. These PLIGA assessments are levied for a period of eight years, 1990-97. As noted, the surtax and the assessments were used to reduce the JUA's deficit. *Ibid.*

Neither the surtaxes nor the assessments could be included as normal expenses in the ratemaking process. *Id.* at 44-45, citing *N.J.S.A.* 17:30A-16b (assessments) and *N.J.S.A.* 17:33B-51 (surtaxes). However, the Fair Act did say: "To provide a healthy and competitive automobile insurance system in this State, automobile insurers are entitled to earn an adequate rate of return through the ratemaking process." *N.J.S.A.* 17:33B-2g. The intent of this section was "to make certain that any lessening of insurers' profits due to the surtaxes and assessments would not preclude a constitutionally adequate rate of return." *State Farm, supra,* 124 *N.J.* at 61. Regulations adopted

by the Commissioner on January 25, 1991 (23 *N.J.R.* 514 (Feb. 19, 1991)), precluded a rate increase based on payment of the assessments or surtaxes unless the Commissioner finds that "an increase in revenue is necessary to ensure that the insurer earns a constitutionally adequate return." *N.J.A.C.* 11:3-16.11(d). If rate relief is deemed necessary, "the Commissioner shall determine whether the rate should be adjusted immediately or over time, as may be appropriate." *N.J.A.C.* 11:3-16.11(f).

The regulations do not specify the "constitutionally adequate return," nor do they inform insurers how the Commissioner might propose to compute the achieved return. Rather, the Commissioner left it to the applicant to "present in its filing a formula it believes appropriate for determining the return required by relevant constitutional principles, with supporting analysis and data fully explaining why such formula should be utilized." *N.J.A.C.* 11:3-16.11(e).

All parties agreed that determining an insurer's fair rate of return in a retrospective proceeding presented a formidable task, because of the absence of any recognized methodology for (1) defining a minimally acceptable rate of return, and (2) computing that return. State Farm, DOI and Rate Counsel all assembled highly-qualified experts to submit reports and testify before the ALJ. Appearing for State Farm were Steven Lehmann, an actuary; Dr. Irving Plotkin, an economist; Gary Ransom, an investment advisor; and Richard Stewart, among other things, former president of the National Association of Insurance Commissioners (NAIC). Testifying for DOI were consultants and economists Blaine Nye and Bryan Sullivan and Assistant Commissioner Martin Rosenberg. Rate Counsel presented two experts, Allan Schwartz, president of an actuarial consulting firm, and economist David Parcell.

IV

Several important conceptual categories must first be explained.

A. *Fair Rate of Return*

There was no dispute on certain underlying principles. First, insurers are entitled to an opportunity for a fair rate of return; they are not guaranteed that return. Second, the actual return will vary from year to year, due to a number of factors. Thus, one cannot simply examine an earned rate of return and conclude that a company was denied the opportunity to earn a fair rate of return. Third, the fair rate of return in a prospective proceeding is one needed to attract investors, often called by the experts the cost of capital. Fourth, since cost of capital is a prospective concept, it is difficult to determine what is a fair rate of return in a retrospective proceeding. Ransom for State Farm explained that "Fair rates of return from an investor's or insurance management's point of view have meaning only in a prospective sense" since the decision to commit capital to such an enterprise "is triggered only by the prospective returns that investors and management expect to earn in the future." Schwartz explained for rate counsel that "cost of capital is a prospective concept." He was unaware of any authority explaining "how to determine in a specific way what a retrospective fair rate of return is." [1]

One major aspect of disagreement was the fair rate of return for the New Jersey automobile insurance industry

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[1] Cost of capital is a purely theoretical concept in State Farm's case, since State Farm is a mutual company, which means it does not seek to attract capital and needs no profit to attract capital. The so-called Clifford hearings, which determined how to set rates for automobile insurance, *see In re Application of Ins. Rating Bd.*, 63 *N.J.* 413 (1973), decided that for rate-making purposes, mutual companies and stock-based companies should be treated in the same way.

for the years involved 1990 and 1991. State Farm's experts posited a rate return of between 16 and 19%, premised on the theory that this high rate was necessary because automobile insurance has historically been a risky business in New Jersey; Lehmann said 16%, Plotkin said 19%; Ransom said between 17 and 19%. Several factors made New Jersey uniquely risky: the difficult and burdensome regulatory climate, involving a great deal of paperwork and lengthy delays for rate increases; the requirement that New Jersey automobile insurers take on bad risks; New Jersey's long history of operating losses (according to the Department of Insurance, insurers lost money on private passenger autos in ten of the thirteen years between 1976 and 1989, and during that thirteen-year period, operating losses were more severe in New Jersey than in any other state); the strict limitations on profits imposed by the Excess Profits Law; the surtax and assessment; enormous unfunded PIP claims and MTF losses; and a biased, "heads I win—tails you lose" administrative structure for rate increases. The November 1989 edition of the *Insurance Reporter,* DOI's "official newsletter," recounted the long history of operating losses on PPA. On the other hand, other property and casualty lines, such as workers' compensation, commercial auto or homeowners, have in the past been more profitable in New Jersey than in the nation as a whole.

Parcell, for Rate Counsel, who testified for the purpose of establishing the cost of capital for each year between 1985 and 1991, focused not on the risks inherent in the private passenger automobile side but analyzed all lines of business. Using three different methodologies to estimate rate of return for the property and casualty insurance industry, he concluded that the cost of equity was about 13% for 1990 and 1991. As he understood the Commissioner's regulations, an insurer cannot recover unless it shows confiscatory rates on all of its lines, and therefore he looked at all lines.

The ALJ held that determining fair rate of return "requires an all-lines analysis" and he agreed with Parcell's conclusion that, in a prospective proceeding, "the investors' long-term expected or required return is in the area of 13.0 percent." He added that 13% "is an approximation of the center of the range of reasonableness for the fair rate of return." The Commissioner agreed with this conclusion. We note that 13% is very close to the rate of return allowed by the Clifford formula. *See N.J.A.C.* 11:3-16.10. Under the Clifford formula, rates are fixed so that an insurance company can earn a post-tax profit of 3.5% of its premiums. *Matter of Orders A-92-189 and A-92-212*, 274 *N.J. Super.* 385, 389 (App. Div. 1993), *aff'd o.b.* 137 *N.J.* 93 (1994). To convert operating profit to return on equity the standard formula, according to DOI, is to multiply the operating profit percentage by two and then increase the percentage by seven, to account for investment income on insurers' capital and surplus funds. *Insurance Reporter* (November 1989). For purposes of this appeal, State Farm does not dispute that 13% is a fair rate of return.

The ALJ and the Commissioner proceeded to hold that 13% was not the minimally acceptable rate of return in a retrospective proceeding. Schwartz, Nye and Sullivan all thought that, because profits in the industry varied widely from year to year, a fair rate of return can be considerably less than 13%. Using a statistical device known as a "confidence interval," Schwartz concluded that a reasonable rate of return in a retrospective proceeding could range between 2.6% and 18.8%, while Nye said that an actual one-year return of between –3.6% and 35.6% would indicate a company earned a fair rate of return and Sullivan thought that a return of between –3.48% and 29.6% could be a reasonable return. The Commissioner adopted the ALJ's finding that returns in the vicinity of –3.6% to 2.6% represented the "low end of the range of reason-

ableness" in a "retrospective analysis limited to one year for private passenger automobile insurance."

B. *Actual or Achievable Rate of Return*

While holding that an all-lines analysis is more appropriate, the ALJ computed State Farm's achieved rate of return on its private passenger auto lines only. He adopted Rate Counsel expert Schwartz's analysis of State Farm's income and expenses on its private passenger automobile insurance for the years 1990 and 1991. The ALJ concluded that for 1990 State Farm realized a 12.7% rate of return without payment of the surtax and assessment, and a 3.4% rate of return with payment of the surtax and assessment. For 1991 the rate of return was 16.4% without payment, and 7.5% including the surtax and assessment. Noting that the "average of these returns is higher than the achieved rate of return of 4.8% for countrywide private passenger automobile insurance," the ALJ concluded State Farm's actual return was well within the range of reasonableness.

Having decided that State Farm had achieved a fair rate of return for the two years in question, the ALJ found it unnecessary to decide whether, as alleged by DOI and Rate Counsel, State Farm's profits were actually higher because (1) State Farm over-reserved, thus inflating losses, and (2) State Farm was slow to implement permitted rate increases, such as flex rate increases, thus reducing its income. There was disputed evidence on both items; DOI claimed that prompt implementation of permissible rate increases could have netted State Farm an additional eight or nine million dollars in premiums and also that State Farm had over-reserved. State Farm denied this.

State Farm claimed a –12% rate of return for 1990; the ALJ found a 3.4% rate of return. For 1991, State Farm's calculation showed a –3.5% rate of return; the ALJ found that the return was 7.5%. This difference

between the ALJ's conclusion and State Farm's claims is largely attributable to three items: (1) loss adjustment expenses (LAE); (2) Automobile Insurance Risk Exchange (AIRE) expenses, and (3) investment income on policyholder funds. We summarize the factual dispute on each item.

1. *LAE.*

For 1990 State Farm claimed about $6,000,000 more in loss adjustment expenses than found by the ALJ; for 1991, the difference was about $10,000,000. State Farm used the LAE from the excess profits report, explaining that specific New Jersey loss adjustment expenses were higher than in the nation as a whole because New Jersey was a more expensive place to do business. Lehmann, State Farm's actuarial expert, claimed that Schwartz erred in estimating State Farm's LAE in New Jersey by using a ratio of New Jersey losses to countrywide losses. He should have used State Farm's actual New Jersey LAE shown in the excess profits report, since that reflects State Farm's actual performance in New Jersey. Over the past several years State Farm's LAE ratio was higher in New Jersey than countrywide, because of differences in tort systems, their complexities, the amount of legal expenses incurred in adjusting claims, cost of purchasing land and building for claims service centers, salaries for claims managers and employees and vehicle storage costs. One significant factor in State Farm's higher LAE for New Jersey is that claimants in New Jersey are more likely to be represented by an attorney. In New Jersey about 61% have attorneys; nationwide about 45%. Where claimants have attorneys, State Farm requires counsel. This increases the LAE.

Schwartz, Rate Counsel's expert, calculated LAE by using a countrywide ratio because the higher level reported for New Jersey "has not been explained or justified in any way by State Farm." Rate Counsel contended that losses per automobile in New Jersey are among the highest in

the country and that higher loss adjustment expenses in New Jersey relative to the countrywide data do not necessarily explain the higher ratio of loss adjustment expenses to losses. Schwartz had "no way of knowing . . . if the reported New Jersey loss adjustment expenses reported by State Farm are subject to any audits, controls or checks." Schwartz testified that he was not sure whether the numbers reported in the excess profits report are subject to a verification or audit. The ALJ accepted Rate Counsel's position and the Commissioner agreed, saying that State Farm had not met its burden of proof because only the countrywide ratio was subject to audit and verification.

2. *AIRE Expenses.*

AIRE expenses are explained in an unpublished 1991 opinion of this court, as follows:

> Private passenger automobile insureds must now select one of two lawsuit thresholds, the verbal threshold or the zero-dollar threshold. *N.J.S.A.* 39:6A-8. By selecting the verbal threshold, the insured pays a lesser premium, but his right to sue for noneconomic loss is significantly reduced. If the insured selects the zero-dollar threshold, he pays a higher premium, but does not surrender his right to seek damages for pain and suffering. The dual threshold system causes an inequity among insurance companies. AIRE is designed to remedy this imbalance by a system of assessments, based upon premiums received from insureds selecting the zero-dollar threshold, and by reimbursements, based upon an insurer's total bodily injury claims. Insurers with higher risk policyholders will receive more money back from AIRE than insurers with lower risk policyholders. State Farm has been a net payer since 1984, since it has paid more assessments to AIRE than it has received reimbursements.
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> [*In the Matter of the Commissioner of Insurance's denial of State Farm Mutual Auto Insurance Com-*

pany's Request for a Private Passenger Automobile Rate Revision, No. A-4601-90T2 (App. Div. December 26, 1991) (slip op. at 3-4).]

There, this court held that AIRE expenses need not be included in prospective ratemaking.

State Farm paid over $8,000,000 in AIRE expenses in 1990, and over $6,000,000 in 1991. State Farm included AIRE expenses in computing its realized return because they were an actual cost of doing business and reported on the excess profits report. Rate Counsel's expert Schwartz declined to include AIRE expenses because, as held by this court, they were not to be taken into account in prospective ratemaking. The ALJ acknowledged that State Farm had presented a strong argument for including AIRE expenses, since they were in fact an actual cost of doing business, but he excluded them because the Commissioner "has specifically rejected the view that assessments and reimbursements by AIRE should be reflected in rates." The Commissioner agreed with the ALJ, explaining that: "(1) it is too speculative as to whether State Farm would continue to be a net payer; and (2) to permit one insurer to adjust its rates on the basis of AIRE assessments could well distort the industry-wide mechanism."

3. *Investment Income on Policyholder-supplied Funds.*

This dispute focuses on a very technical problem, the method for computing an insurer's investment income on policyholder-supplied funds. Rate Counsel's computation was about $4,000,000 higher for 1990 than State Farm's, and about $2,000,000 higher for 1991. However, Nye, DOI's economist, attributed a much greater sum to State Farm, the difference being over $10,000,000 in 1990 and almost $14,000,000 in 1991. The ALJ approved Rate Counsel's analysis but the Commissioner agreed with Nye. State Farm used the figures from its excess profits report.

State Farm condemned Nye's approach because it included net income from State Farm's Canadian operations and funds received from an affiliate.

The Commissioner made one other major policy decision, he included unrealized capital gains and losses in computing fair return on a retrospective basis. State Farm had a relatively small unrealized capital loss in 1990, the effect of which would decrease its achieved return by about 2%. It had an unrealized capital gain in 1991, the effect of which would have increased the achieved return by about 10%. The ALJ did not consider unrealized capital gains and losses because they are generally not recognized for prospective ratemaking purposes and because they tend to offset each other over time. But, he cautioned, "if emphasis is to be placed on State Farm's actual experience in 1990 and 1991, these unrealized capital gains could well be considered." The Commissioner concluded that they should be considered, reasoning the "ALJ's statement that unrealized capital gain and losses generally are not recognized for ratemaking purposes is correct, but the present matter is outside the scope of normal [prospective] ratemaking and all of State Farm's usual investment returns should be considered."

V

State Farm contends that the surtaxes and assessments deprived it of a fair rate of return for 1990 and 1991. For purposes of argument on this appeal, State Farm accepts the conclusion of the Commissioner and the ALJ that 13% is a fair rate of return and seems to accept, for argument's sake, the ALJ's factual findings, which were not questioned by the Commissioner, that its actual rate of return on its private passenger auto lines was 3.4% in 1990 and 7.5% in 1991. State Farm contends that these findings perforce entitle it to relief and also urges that the ALJ and the Commissioner erred in employing the so-called "confidence intervals" to justify a lower rate of return than 13%.

DOI responds that the 13% figure applies only in a traditional ratemaking proceeding, where rates are set on a prospective basis. An insurer's failure to achieve that rate in a particular year does not result in a constitutional deprivation, since actual returns vary from year to year. Ratemaking is not a guarantee against all vagaries of the business cycle. DOI and Rate Counsel claim that in this retrospective proceeding, State Farm failed to show denial of a fair rate of return.

Our standard of review is clear. In *State Farm, supra,* the Court concluded that, in enacting the Fair Act, the Legislature "deliberately left to the Commissioner of Insurance the determination of the precise constitutionally required rate of return, as being within the area of expertise entrusted to the Department of Insurance in its long exercise of the ratemaking function." *State Farm, supra,* 124 *N.J.* at 61. Administrative action is upheld unless it is arbitrary, unreasonable or capricious. *Matter of Aetna Casualty & Surety Co.,* 248 *N.J. Super.* 367, 376 (App. Div.), *certif. denied,* 126 *N.J.* 385 (1991), *cert. denied,* 502 *U.S.* 1121, 112 *S. Ct.* 1244, 117 *L. Ed.* 2nd 476 (1992). Under that standard, a reviewing court asks itself the following questions:

> (1) whether the agency's action violated the enabling act's express or implied legislative policy;
>
> (2) whether there was substantial evidence on the record to support the findings on which the agency based its actions;
>
> (3) whether in applying the legislative policies to the facts, the agency clearly erred by reaching a conclusion that could not reasonably have been made after weighing the relevant factors.

Williams v. Department of Human Services, 116 *N.J.* 102, 107 (1989); *Public Service Electric & Gas Co. v. D.E.P.E.,* 101 *N.J.* 95, 103 (1985). "The burden is on

the objector to overcome the presumption that agency actions are valid and reasonable." *Matter of Aetna Casualty & Surety Co., supra,* 248 *N.J. Super.* at 376. Moreover, the "Commissioner's expertise in the field of insurance must be given great weight." *Ibid. Accord Matter of Orders A-92-189 and A-92-212,* 274 *N.J. Super.* 385, 398 (App. Div. 1993), *aff'd o.b.* 137 *N.J.* 93 (1994).

State Farm argues for a less deferential standard, contending that this appeal presents purely legal issues which are uniquely within the province of this court to decide. *See Mayflower Securities v. Bureau of Securities,* 64 *N.J.* 85, 92-93 (1973). State Farm denies that resolution of this matter hinges on any factual findings or that the Commissioner's expertise is involved when determining State Farm's constitutional rights. However, the Supreme Court's conclusion that the Legislature deliberately vested in the Commissioner the initial determination of the required rate of return, as within his expertise, 124 *N.J.* at 61, requires us to reject State Farm's argument for a virtually de novo review. *See N.J. Bell Tel. Co. v. State,* 162 *N.J. Super.* 60, 73 (App. Div. 1978).

"Whether a particular regulation of prices fails to permit a just and reasonable return is a mixed fact-law question." *Hutton Park Gardens v. West Orange Town Council,* 68 *N.J.* 543, 570 (1975). The party alleging confiscation has the burden of proof. *Ibid.* The federal Supreme Court has declared it "obvious that reviewing courts will require criteria more discriminating than justice and arbitrariness if they are sensibly to appraise" a rate order. *Permian Basin Area Rate Cases,* 390 *U.S.* 747, 790, 88 *S. Ct.* 1344, 20 *L. Ed.* 2d 312, 349 (1968). This involves a three-fold inquiry:

> First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine

> the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide protection to the relevant public interests, both existing and foreseeable.
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> [*Permian Basin, supra,* 390 *U.S.* at 791-92, 20 *L. Ed.* 2d at 350.]

Accord N.J. Bell Tel. Co., supra, 162 *N.J. Super.* at 73.

> The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. Judicial review of the Commission's order will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes of which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry. [*Permian Basin, supra,* 390 *U.S.* at 792, 20 *L. Ed.* 2d at 350.]

In *State Farm,* our Supreme Court endorsed the standards developed by the United States Supreme Court in a series of cases dealing with government price regulation of public utilities and by the Court in rent control cases. *State Farm, supra,* 124 *N.J.* at 47. The basic rule is tersely stated: "If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments." *Duquesne Light Co. v.*

Barasch, 488 *U.S.* 299, 308, 109 *S. Ct.* 609, 102 *L. Ed.* 2d 646, 657 (1989). "Sufficient compensation" has, since 1944, been defined as "enough revenue not only for operating expenses but also for the capital costs of the business." *Federal Power Commission v. Hope Natural Gas Co.*, 320 *U.S.* 591, 603, 64 *S. Ct.* 281, 88 *L. Ed.* 333, 345 (1944).

> By that standard the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.
>
> [*Ibid.*]

What that standard should be in any given case presents a vexing question. Neither "law nor economics has yet devised generally accepted standards for the evaluation of ratemaking orders." *Permian Basin Area Rate Cases, supra*, 390 *U.S.* at 790, 20 *L. Ed.* 2d at 349. *Accord Duquesne Light Co., supra*, 488 *U.S.* at 308, 102 *L. Ed.* 2d at 657. "The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result." *Id.*, 488 *U.S.* at 314, 102 *L. Ed.* 2d at 661.

Given these complexities, courts have opted for a "bottom line" approach. Thus:

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.
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> [*Hope Natural Gas, supra*, 320 *U.S.* at 602, 88 *L. Ed.* at 345.]

Accord Duquesne Light Co., supra, 488 *U.S.* at 310, 102 *L. Ed.* 2d at 658-59.

What this standard means in the context of insurance rate regulation has been the subject of several opinions in other jurisdictions. Generally, rates must be higher than necessary to avoid insolvency—a scheme allowing a rate increase only upon a showing of insolvency violates the just and reasonable return standard. *Calfarm Ins. Co. v. Deukmejian,* 771 *P.*2d 1247, 1254 (Cal. 1989). Rates which merely allow an insurer to break even do not permit a fair and reasonable return. *Guaranty National Ins. Co. v. Gates,* 916 *F.*2d 508, 515 (9th Cir. 1990). It is impermissible to set rates so low that the insurer must subsidize them with profits from other states. *Id.* at 513-14; *Calfarm, supra,* 771 *P.*2d at 1254. Rates cannot be set at a level below the fair rate of return to make up for allegedly excessive profits in the past. *Ibid.*

In rejecting an insurance commissioner's claim that insurers have the choice of submitting to confiscatory rates or getting out of the insurance business, Massachusetts's highest court held:

> The Commonwealth's admitted power to regulate the insurance business and the rates which are charged for insurance does not permit it to limit the conduct of such business to those companies which submit to whatever rates the commonwealth may fix, even if they be confiscatory. The writing of insurance is a lawful business and the commonwealth may not impose unconstitutional conditions upon the exercise of the right to engage therein.
>
> While it is not constitutionally required to fix rates which will guarantee a profit to all insurers, it may not constitutionally fix rates which are so low that if the insurers engage in business they may do so only at a loss. The insurers are not required to either submit to confiscatory rates or go out of busi-

> ness. They have a right to rates which are not confiscatory, or which satisfy any higher applicable statutory standard; and to a judicial review on the constitutional statutory adequacy of such rates.
>
> [*Aetna Casualty & Surety Co. v. Commissioner of Ins.*, 263 *N.E.*2d 698, 703 (Mass. 1970) (citations omitted).]

On the other hand, a recent California case suggests that an insurer may have a legitimate interest in a fair rate of return on capital but no absolute right thereto. *20th Century Ins. Co. v. Garamendi*, 878 *P.*2d 566, 632 (Cal. 1994). An insurer's interest in rates which provide enough revenue for operating expenses and the capital cost of doing business must be balanced against the interests of the public in lower prices for insurance. *Id.* at 635-36.

The analysis of the constitutional requirements for price controls in *20th Century* may indeed be at odds with the standards announced by our Supreme Court. In *State Farm, supra*, the Court stated that "the constitutional requirement that a business be permitted a return sufficient to assure its financial health does not necessarily require any particular level of profit *above what is adequate to attract and retain invested capital.*" 124 *N.J.* at 48 (emphasis supplied). *See also Transcontinental Gas v. Bernards Tp.*, 111 *N.J.* 507, 525 (1988) (rate of return should be sufficient to provide investors with a reasonable return on capital). Put another way, "price controls which do not permit an economically efficient operator to obtain a 'just and reasonable return' on his investment are deemed confiscatory." *Hutton Park Gardens v. West Orange Town Council, supra*, 68 *N.J.* at 568.

State Farm posits that its failure in 1990 and 1991 to achieve a fair rate of return, 13%, as defined by the ALJ and the Commissioner, automatically entitles it to relief. We reject the argument given the finding by the ALJ

that State Farm's rate of return for PPA in New Jersey for 1990 and 1991 approximated the actual PPA rate of return for all insurers' nationwide. The effect of the surtaxes and assessments was to reduce State Farm's rate of return on PPA to roughly the industry average for the questioned years. The "takings" clause requires no remedy where the effect of price regulation has been to reduce actual return to the industry average.

The 13% figure advocated by rate counsel and accepted by the ALJ and Commissioner is the rate which would be "fair" in a prospective ratemaking setting. One of the major difficulties in this case, recognized by the parties, the ALJ and the Commissioner, is the absence of any precedent for determining fair rate of return in a retrospective context. Normally, of course, ratemaking is a legislative function and will only be exercised prospectively. *Petition of Elizabethtown Water Co.*, 107 *N.J.* 440, 452-53 (1987). In the insurance context, it requires the insurer to "predict the future performance in order to establish a premium that will generate the appropriate rate of return." *Matter of Orders A-92-189 and A-92-212, supra,* 274 *N.J. Super.* at 390. By definition, retroactive ratemaking occurs when a regulated company is permitted to recover an additional charge for past losses, or where the company is required to refund revenues already collected under previously established rates. *Petition of Elizabethtown Water Co., supra,* 107 *N.J.* at 448.

There is no constitutional proscription against retroactive ratemaking but statutes are normally construed to prohibit it because of the practical difficulties it entails. *Petition of Elizabethtown Water Co., supra,* 107 *N.J.* at 450-54. We have recently concluded that the Commissioner's regulations authorize him to set higher rates prospectively to offset past losses which caused returns to go below the constitutionally required fair rate of return. *Matter of Commissioner of Insurance's Decision on Liberty Mutual Fire Ins. Co. Rate Filing,* 266 *N.J. Super.*

457, 467-68 (App. Div. 1993) (citing *N.J.A.C.* 11:3-16.11(f)). *Accord Nationwide Mutual Ins. Co. v. Foster*, 739 *F. Supp.* 962, 964 (M.D. Pa. 1990). Neither DOI nor Rate Counsel here challenges the right or the duty of the Commissioner to engage in retroactive ratemaking to offset the effect of the surtaxes and assessments which have precluded a fair rate of return. The problem facing the ALJ and the Commissioner was to determine what was a fair rate of return in the context of this retrospective proceeding.

State Farm's argument that it is constitutionally entitled to the difference between 13% and its realized return suffers from two misconceptions: (1) 13% is the "fair" rate of return in a retrospective proceeding, and (2) 13% is the minimally acceptable rate of return. The highly qualified experts presented said that 13% is a *goal* in a prospective proceeding but many factors could explain a return of less than 13% in any given year. No one suggested that an insurer who earned less than a prospective 13% was constitutionally entitled to relief.

As to the second point, State Farm overlooks the principle that regulation may stringently limit return on investment, that investors' interests must be balanced by consumers' interests, and that investors must anticipate that profit levels can be capped or significantly reduced by changes in government regulation. *State Farm, supra,* 124 *N.J.* at 48-50. *Accord Permian Basin, supra,* 390 *U.S.* at 769; 20 *L. Ed.* 2d at 337; *Hope Natural Gas, supra,* 320 *U.S.* at 603, 88 *L. Ed.* at 345. Although the experts took somewhat varying approaches in computing rate of return, there is some correlation between the target figure of 13% and average return in the industry. Rate Counsel expert Schwartz determined fair rate of return on a retrospective basis by examining actual returns earned by property and casualty insurers over an extended period of time, between 1973 and 1991. The

methodology employed by Rate Counsel's other expert, Parcell, was considerably more complex but one major component was examining historical returns in the property and casualty industry to arrive at a fair rate of return. The target rate of return was very close to the return permitted by the Clifford formula (see *infra* at 13) in prospective ratemaking. Insurers cannot obtain rate relief whenever their profits in a given year fall below the target simply because they can prove some causal relationship between a governmental policy and the reduced profit.

If an average return is around 13%, some insurers must earn less than that average and some more. As noted by the ALJ: "Obviously, an insurer cannot expect to achieve an average return each year considering the volatility and cyclicality of earnings in the insurance industry." *Accord Matter of Orders A-92-189 and A-92-212, supra,* 274 *N.J. Super.* at 390. The ALJ found that the average return nationwide for private passenger automobile insurance in 1990 was 4.8%. This number finds support in the record. The ALJ reached the conclusion that State Farm was not entitled to relief because its actual New Jersey returns were not significantly different from nationwide returns, explaining:

> With respect to the achieved rates of return of 12.7 percent for 1990 and 16.4 percent for 1991 excluding surtaxes and assessments, these returns are within the range of reasonableness and average slightly above the mid-point. The achieved rates of return of 3.4 percent in 1990 and 7.5 percent in 1991 including surtaxes and assessments are also within the range of reasonableness for realized returns in specific years. It is particularly noteworthy that the average of these returns is higher than the achieved rate of return of 4.8 percent for countrywide private passenger automobile insurance. In regard to the mid-point of the range of reasonableness, an insurer obviously cannot expect to achieve a rate of return

> equal to or above the long-term average return in each and every year. Achieved returns below the mid-point in some years are to be expected.

This conclusion finds support in the testimony of DOI expert Nye, who said that if State Farm achieved approximately the same rate of return as the industry as a whole nationwide, then there is no "reason to conclude that anybody is systematically fooling around with State Farm's right to make a profit." Since the actual returns were roughly the same, "it doesn't appear there was any interference with State Farm's ability to earn a fair rate of return in those years."

State Farm contends that other factors caused notably low returns in the property casualty industry for the year 1990 citing a report of DOI expert Sullivan who discussed a Forbes Magazine article characterizing the year 1991 as a year the industry "would like to forget" because of the "takeover of certain major life insurance companies, a deteriorating market for commercial property and casualty policies, and some portfolio adjustments which proved to be poorly timed." The relevance of this testimony as to the fair rate of return for private passenger auto escapes us. The cited circumstances would not impact on PPA. According to Nye's analysis, over a six-year period countrywide, PPA earned significantly less than the property casualty insurance industry as a whole. The six-year countrywide average (1986-1991) for PPA was 7.3%, compared to 13.2% for the property casualty industry as a whole. Indeed, the 1989 results for PPA, 4.8%, were the same as those achieved in 1990.

Certain case precedent not available to the ALJ, the Commissioner, or the parties at the time their briefs were written in this case supports the use of historic returns as a method of computing a fair rate of return in a retrospective proceeding. *20th Century Ins. Co. v. Garamendi, supra,* 878 *P.*2d 566. Prior to 1988, California operated

on an open-competition system, under which insurers could allow the marketplace to dictate premiums for property and casualty insurance. *Id.* at 580. *See also Calfarm Ins. Co. v. Deukmejian, supra,* 771 *P.*2d at 1257. In November 1988 California voters adopted Proposition 103, which authorized the commissioner of insurance to set rates, and, of importance here, required premiums on auto rates for the year 1989 (the rollback year) to be 20% lower than those in effect on November 8, 1987. *Id.* at 1250. The rollback applied to all auto insurers except those who the commissioner of insurance found would be threatened with insolvency. *Id.* at 1250. Although the California Supreme Court found this provision facially unconstitutional, *id.* at 1253, it was severable from the remainder of Proposition 103. *Id.* at 1256. Insurers who believed the 20% reduction was confiscatory could apply to the commissioner for relief, and could charge higher premiums pending a hearing. *Id.* at 1258-59. *Accord Firemans' Fund Ins. Co. v. Garamendi,* 790 *F. Supp.* 938, 941 (N.D. Cal. 1992).

In response, 460 insurers filed over 4000 applications for exemptions from the rollback requirements, as well as over fifty lawsuits. *Id.* at 941-42. The commissioner adopted regulations which set the fair rate of return in a retrospective proceeding at 10%. *Id.* at 944. *Accord 20th Century, supra,* 878 *P.*2d at 587. The insurer was obligated to refund the amount of premium charged in the rollback year that exceeded 80% of the 1987 rate *or* such rate greater than 80% of the 1987 rate as was minimally nonconfiscatory. *Id.* at 589.

California's insurance commissioner settled on the 10% rate of return by using historical averages, that is, the commissioner calculated that between 1980 and 1989 the property and casualty industry earned an average of a 10% return under both statutory accounting principles and generally accepted accounting principles. *Id.* at 591. Insurers challenged the constitutionality of both the ap-

proach and the result. The Supreme Court held: "There is certainly nothing confiscatory in the definition of 10% as the lower boundary of the range of reasonable rates of return." *Id.* at 624. Applying the arbitrary, unreasonable and capricious standard to both the commissioner's approach and the result, the court held that the commissioner did not improperly exercise his discretion in using historic averages to calculate a reasonable rate of return in a retrospective proceeding. *Id.* at 623.

We find this aspect of the California Supreme Court's opinion soundly reasoned: it provides the only precedent available for setting a fair rate of return in a retrospective proceeding.[2] We conclude that State Farm was not entitled to specific monetary relief in this rate hearing and on this appeal because (1) computing rate of return on a retroactive proceeding based on historical averages is not unconstitutional; (2) government price regulations may severely limit the return on investment, *State Farm, supra,* 124 *N.J.* at 48; and (3) the actual impact of the regulation controls. *Duquesne Light, supra,* 488 *U.S.* at 314, 102 *L. Ed.* 2d at 661. Simply put, on this record, the impact of the government regulation here was to reduce State Farm's rate of return to about the return of all PPA insurers for the country as a whole for the years in question. We are satisfied that the final decision of the Commissioner did not operate as a constitutional taking of State Farm's property or deprive it of a fair rate of return on property.

VI

We next address State Farm's contention that the Commissioner misused a statistical device known as "confidence intervals" to reach the conclusion that a return

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[2] We do believe that the suggestion that insurers have no constitutional right to a fair rate of return, *20th Century, supra,* 878 *P.*2d at 632-33, is inconsistent with the standard announced by the Court in *State Farm, supra,* 124 *N.J.* at 47-50.

below zero in a particular year could be constitutionally adequate. This was an attempt to determine a reasonable range of fluctuation, or a standard deviation, from an optimum or normative return, all of which was complicated by the novel retroactivity analysis.

For example, Schwartz for Rate Counsel explained his approach:

> In order to determine a fair rate of return, on a retrospective basis, we examined the actual return earned by the property casualty insurance industry over an extended period of time. This allows for a determination to be made of the prospective fair rate of return—by examining the average return. It will also allow for a determination to be made of the possible fluctuations around this prospective fair rate of return—by examining the standard deviation of the returns. These return values are shown in Exhibit AIS-9.
>
> From 1973 to 1991—a nineteen year period—the property casualty insurance industry had an average return of 10.7%. The standard deviation of the return was 4.9%. Based upon this, we determined that a reasonable range for the actual rate of return—on a retrospective basis—was 2.6% to 18.8%. This range was based upon a common practice of using a 90% confidence interval when performing statistical testing. Since State Farm's actual profitability—after consideration of the surtax and assessment—was within this range, it can be concluded that State Farm had the opportunity to earn a fair rate of return during 1990 and 1991. It is also interesting to note that the property/casualty insurance industry's average rate of return during 1990 and 1991 combined was 8.6%. State Farm's New Jersey private passenger automobile insurance profitability—even without considering unrealized capital gains and excessive reserves—was 6.6%. This small difference

> in return is further evidence that State Farm had the opportunity to earn a fair rate of return in 1990 and 1991.

Nye and Sullivan for DOI used somewhat more expansive "confidence intervals," –3.6% to +35.6% and –3.48% to +29.26%, respectively. The ALJ agreed with these experts, reasoning:

> Obviously, an insurer cannot expect to achieve an average return each year considering the volatility and cyclicality of earnings in the insurance industry. Under the circumstances, a range of reasonableness is necessary for a retrospective analysis of returns in the insurance industry. Based upon the presentations of DOI and Rate Counsel, I accept returns in the vicinity of –3.6 percent to 2.6 percent as the low end of the range of reasonableness for a retrospective analysis of one year.

The Commissioner adopted these findings.

Rate counsel offers what appears to be an accurate definition of a "confidence interval," explaining that it is a "statistic which measures the probability that the reserved results (*e.g.*, retrospective actual rate of return) will fall within a reasonable range around the expected result (*e.g.*, prospective fair rate of return)." It is a device used when numerical calculations are derived from samples rather than from a measurement of the entire population. David W. Barnes & John M. Conley, *Statistical Evidence in Litigation* § 3.14 at 106-07 (1986). When calculations are derived from samples, "an element of uncertainty is introduced and resulting estimates or predictions are inherently less precise." *Ibid.* A "confidence interval" establishes a range above, below or around the sample which tends to confirm the accuracy of the number. *Id.* at § 3.15 at 107. *Accord DeLuca v. Merrell Dow Pharmaceuticals, Inc.*, 911 *F.*2d 941, 948 (3rd Cir. 1990). It has a variety of uses in litigation, a common case being where a plaintiff uses studies drawn

from samples to establish that a drug caused a particular injury. *Ibid. See also Brock v. Merrell Dow Pharmaceuticals, Inc.*, 874 *F.*2d 307, 311-13 (5th Cir. 1989). In a recent death penalty case, where the Court undertook a proportionality review and noted that a "confidence interval simply designates the chance, expressed as a percentage, that a defendant's case will fall within a certain range of predicted probabilities of receiving a death sentence." *State v. Martini*, 139 *N.J.* 3, 43 (1994).

We agree with State Farm that there may be flaws in the analysis expounded by the experts and adopted by the Commissioner, some of which were recognized by the experts themselves. The Commissioner reasonably concluded that an insurer who demonstrates a negative –3.6% rate of return for one year does not necessarily establish that the State regulatory scheme effected a taking of its property, entitling the insurer to relief. Too many other factors could have caused a low rate of return. The insurer bears the burden of proving that *the* surtaxes and assessments denied it a fair rate of return. *See Hutton Park Gardens v. West Orange Town Council, supra*, 68 *N.J.* at 570. *Cf. State Farm, supra*, 124 *N.J.* at 60 (Commissioner's regulations provide a procedure for separate rate-filings by insurers "who can demonstrate that payment of the surtaxes and assessments has denied them a fair rate of return").

In this case State Farm offered proof that it experienced no unusual casualties or other factors which reduced its rate of return on its automobile business and DOI and Rate Counsel experts Schwartz, Nye and Sullivan all conceded that they could find nothing in State Farm's experience in New Jersey, other than the surtaxes and assessments, which would produce the low rate of return which State Farm claimed was confiscatory. Notably, the ALJ made no express finding that State Farm's rate of return was caused by factors other than the surtaxes and assessments.

In view of the agency's conclusion based on substantial evidence in the record that the achieved rate of return was reasonable and not confiscatory, we find no basis for a reversal or a remand simply because of the references to "confidence intervals" in the opinions below. This statistical tool did not drive the analysis or command the conclusion reached at the agency level. Any error in this respect was essentially harmless and certainly not of constitutional dimension.

VII

We need not reach the "all-lines" question, *i.e.*, whether State Farm could obtain relief if it proved that its return in the private-passenger line was confiscatory but otherwise achieved a fair return on an "all line, all years" basis. Since State Farm did achieve a fair return on its personal property auto lines, we eschew as unnecessary any decision on whether other profitable lines may be required, constitutionally or statutorily, to subsidize auto line losses. We should not reach such substantial questions unless absolutely necessary to the disposition of the litigation before us. *O'Keefe v. Passaic Valley Water Commission*, 132 *N.J.* 234, 240 (1993); *Sacks Realty Co., Inc. v. Shore*, 276 *N.J. Super.* 621, 625 (App. Div. 1994). *See Matter of Commissioner of Insurance*, 256 *N.J. Super.* 158, 180 (App. Div. 1992), *aff'd* 132 *N.J.* 209 (1993).

VIII

Finally, we address State Farm's contention it was denied procedural due process because the procedure failed to provide any realistic opportunity for retrospective relief and the agency failed to adopt standards in advance for such relief.

As noted, *infra* at II, the regulations did not specify precisely what constituted a "constitutionally adequate return" nor did they inform insurers how the Commissioner proposed to compute the achieved return. Rather, the Commissioner left it to the applicant to present in its

filing an appropriate formula for determining the return required by relevant constitutional principles "with supporting analysis and data fully explaining why such formula should be utilized." *N.J.A.C.* 11:3-16.11(e).[8]

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[8] The pertinent regulation called for exhaustive data. *N.J.A.C.* 11:3-16.11 states in full:

Rate filings reflecting assessments and surtaxes

(a) All insurers who submit a rate filing which reflects assessments or surtaxes imposed pursuant to *N.J.S.A.* 17:30A-8(a), and 17:33B-49, respectively shall submit such rate filing independently of any prior approval rate filing submitted pursuant to *N.J.A.C.* 11:16.6.

(b) Any insurer desiring to modify its rates to reflect assessments or surtaxes imposed pursuant to *N.J.S.A.* 17:30A-8(9) and 17:33B-49, respectively shall provide the following information in support of its application:

1. All of the data required for prior approval filings submitted pursuant to *N.J.A.C.* 11:3-16.6;

2. A copy of the statutory property and casualty Annual Statement, Exhibit of Premiums and Losses (page 14) for New Jersey for each of the most recent 10 years. The insurer shall also file information combining this data for each of the most recent 10 years for all states and the District of Columbia, if applicable, in which the insurer is authorized to transact business; and shall provide a list of these jurisdictions;

3. The following data for all of its insurance affiliates for each of the most recent 10 years on a Statewide and countrywide basis;

i. For property and casualty affiliates, Exhibit of Premiums and Losses (page 14) of the statutory property and casualty Annual Statement;

ii. For title insurance affiliates, Operations and Investment Exhibit (page 4) and Schedule T—Exhibit of Premiums Written (Page 39) of the statutory title insurance Annual Statement;

iii. For life and health affiliates, Liabilities, Surplus and Other Funds (page 3); Analysis of Operations by Lines of Business (page 5); and Exhibit 1 Part 1 and Part 2 (pages 7 and 7A) of the statutory life and health Annual Statement; and

State Farm specifically contends that the Commissioner denied its right to procedural due process by failing to provide any meaningful backward-looking relief, because

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iv. An estimate of the amount of business in other lines that is produced by the synergistic effects of the insurer writing private passenger automobile insurance in this State.

4. Certifications/representations by the insurer's Chief Financial Officer and President containing the information set forth in Exhibit F in the Appendix incorporated herein by reference;

5. A schedule of Key Performance Indicators (KPI's), as set forth in Exhibit G in the Appendix incorporated herein by reference, for the year of the rate filing and each of the preceding two years;

6. For the current year and preceding two years, a schedule of premiums, incurred losses and operating expenses by New Jersey lines of business corresponding to line items one (1) through twenty-two (22) of Part II of the IEE. In addition, provide a schedule of operating expenses by classification corresponding to line items one (1) through twenty-two (22) of Part I of the IEE. The aggregate of expenses reported by line item must agree with the total operating expenses related to New Jersey policies reported by line of business in Part II of the IEE, (sum of lines four (4) through eight (8));

7. For each line item expenditure included in the schedule required pursuant to (b)6 above, the following:

i. A description of all allocation methodologies used to allocate corporate-wide costs (including worldwide, countrywide and regionalwide costs) to New Jersey lines of business;

ii. A description of allocation methodologies used to allocate operating expenses to New Jersey private passenger automobile liability and physical damage lines of business and to all other New Jersey lines of business;

iii. An explanation for any changes in allocation methodologies between years;

iv. For NJAFIUA/MTF servicing entities which are also insurers, an explanation for differences between allocation methodologies used to prepare the schedule required pursuant to (b)6 above and the methodologies used to prepare Exhibit P of the NJAFIUA/MTF reporting package; and

v. For each operating expense classification by each New Jersey line of business, a schedule which shows the expenses

the Commissioner (1) initially ruled that ratemaking is prospective only, and losses for prior years cannot be recaptured and (2) failed to adopt standards for comput-

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directly charged to a line of business; and indirect expenses allocated to various lines of business using a reasonable allocation methodology;

8. For each New Jersey line of business (including private passenger automobile), the following:

i. The number of named insureds;

ii. The number of employees directly dedicated to the line of business;

iii. The square feet of office space dedicated to the line of business (excluding allocations of corporate or administrative office space);

iv. The hours of data processing time charged;

v. The volume of exposures;

vi. The number of policies in force; and

vii. The number of claims reported during each of the three years requested;

9. A report, based on a study and evaluation of the insurer's system of internal accounting control and signed by an independent public accountant. The report shall state that in the accountants' opinion, the system of internal accounting control of the insurer in effect during the current year, taken as a whole, was sufficient to meet the objectives of a system of internal accounting control insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the insurer's financial statements;

10. A listing of all internal audits performed of the operations of the New Jersey private passenger automobile lines of business during the current year, including the scope of procedures performed;

11. Copies of all internal audit reports issued during the current year pursuant to (b)10 above and management responses to all internal audit findings, which are deemed to be confidential pursuant to *N.J.S.A.* 17:23-6;

12. Access to source documents which, in the opinion of the Commissioner, are necessary to support any and all transactions reported on the insurer's statutory annual statement filed with the Department or to support any other schedules referred to herein;

ing an insurer's achieved return in a retrospective proceeding. The proper remedy, says State Farm, was to require the Commissioner to utilize its excess profits report for

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13. An explanation why the insurer believes that the assessment imposed by *N.J.S.A.* 17:30A-8(9) should be reflected in the requested private passenger automobile rates since the assessment, by statute, is classified as a loan; and

14. Any additional information specifically requested by the Commissioner which may be necessary to evaluate the request for rate relief.

(c) Upon written application and for good cause shown, the commissioner may, in his or her discretion, waive any of the data filing requirements set forth in (b) above.

(d) The Commissioner shall not approve any increase in an insurer's rates on the basis that the insurer is required to pay assessments pursuant to *N.J.S.A.* 17:30A-8(9), or surtaxes pursuant to *N.J.S.A.* 17:33B-49, unless he or she shall find that an increase in revenue is necessary to ensure that the insurer earns a constitutionally adequate return. In making that determination the Commissioner shall consider:

1. The insurer's experience on all lines of its business in New Jersey, and in the case of insurers operating in an insurance holding company system, the experience of all of the lines of business of all affiliated companies in New Jersey, for a period of time over which an insurer could reasonably plan to earn a target rate of return;

2. Whether the insurer and its affiliates, if any, are reasonably efficient in their operations, including claims handling, subrogation and salvage, by comparison to insurers on a statewide and countrywide basis;

3. Whether the insurer and its affiliates, if any, have allocated expenses to New Jersey operations in a fair and equitable manner; and

4. The synergistic effect of mandated private passenger automobile insurance on the sale of other lines of insurance that the filer writes, including, but not limited to, higher premium volumes, lower operating costs and lower acquisition costs.

(e) Each filer shall present in its filing a formula it believes appropriate for determining the return required by rele-

computing achieved return. State Farm accuses the Commissioner of adopting a biased methodology for the sole purpose of enhancing its income and minimizing its expenses, so as to artificially inflate its achieved return.

The Commissioner denies any such bias and claims that sufficient credible evidence supports his findings on each of the disputed income and expense items. He states that had State Farm proven a denial of its right to a reasonable return the remedy would have been higher rates in the future. The Commissioner also disputes State Farm's reliance on the excess profits report, which the Commissioner claims is an inappropriate way of computing return on equity. Neither the Commissioner nor Rate Counsel address State Farm's lack of standards argument, other than an assertion by the Commissioner that State Farm never objected below to a lack of standards.

As to the first contention, the regulations clearly provide that if relief is warranted, "the Commissioner shall determine whether the rate should be adjusted immediately or over time, as may be appropriate." *N.J.A.C.* 11:3-16.11(f). This court held that, by virtue of this regulation, the "Commissioner himself has recognized that it may be appropriate to level off the effect of earlier surtaxes and assessments, in rates applicable to persons who are insured in years other than those in which the surtaxes and assessments have been levied, in order to afford a constitutionally adequate fair rate of return." *Liberty Mutual Rate Filing, supra,* 266 *N.J. Super.* at 468. This

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vant constitutional principles, with supporting analysis and data fully explaining why such formula should be utilized.

(f) The Commissioner may determine whether an insurer's rates are, as a result of the payment of the surtaxes and assessments, constitutionally adequate. In the event that the Commissioner determines that rate relief is deemed to be necessary, the Commissioner shall determine whether the rates should be adjusted immediately or over time, as may be appropriate.

regulation clearly enables the Commissioner to fulfill his constitutional and statutory duty to provide relief if the insurer establishes that, by reason of the surtaxes and assessments, it was unable to achieve a fair rate of return. *Ibid.*

The more meritorious issue here perhaps is the claimed need for standards. State Farm complains that "without advanced standards, the 'hearing' process was meaningless." State Farm asserts that "procedural due process requires government to tell regulated entities in a straightforward manner where and how to obtain relief, including advance identification of the applicable substantive standards, both to permit the regulated entity to determine if an application is warranted and to prevent government from manipulating the process to deny relief." State Farm contends that the existing regulations, while requiring voluminous information from insurers seeking relief, provide "no identification as to how that information is to be used and no methodology to retrospectively compute actual returns." *Ibid.*

The Commissioner asserts, without any particular elaboration, that "standards were clearly articulated." The Commissioner also claims that State Farm never objected to the lack of standards. This is not so. As noted by the ALJ early in the proceedings, on December 5, 1990, State Farm, complaining about the volume of information required, contended that the Commissioner violated due process by failing to disclose the standards by which he would determine whether State Farm earned a fair and reasonable return.

Principles of due process demand that agencies articulate in as much detail as possible the standards that guide discretionary decision-making. *Lower Main Street Associates v. N.J. Housing and Mortgage Finance Agency,* 114 *N.J.* 226, 235 (1989). As noted therein, the Court has "on several occasions invalidated the actions of ad-

ministrative agencies where there was a significant failure to provide either statutory or regulatory standards that would inform the public and guide the agency in discharging its authorized function." *Ibid.* Interested parties need to know the factors which an agency will deem relevant and which might influence its ultimate decision. *Crema v. N.J. Dept. of Environmental Protection*, 94 *N.J.* 286, 302 (1983). Lack of specific standards "results in confusion" to those affected and to the agency itself. *State, Department of Environmental Protection v. Stavola*, 103 *N.J.* 425, 438 (1986).

The Commissioner's regulations do require massive amounts of data, *N.J.A.C.* 11:3-16.11(b), a subject of considerable complaint from insurers when the regulations were initially adopted. *See 23 N.J.R.* 516 (February 19, 1991). According to Lehmann, State Farm's actuary, New Jersey has by far the most cumbersome and burdensome rate-filing requirements in the country, partly because DOI requires information not kept in the ordinary course of business, such as the number of employees directly dedicated to each line of insurance, the square feet of office space dedicated to that line and the hours of data processing time charged by line of business. To supply the information for its March 1990 application for a regular rate increase amounted to over 4100 pages, which took State Farm five months to assemble. It filed an additional 6000 pages for the surtax and assessment filing. But the regulations do not specify how the Commissioner will use this data. They merely state that the Commissioner will "consider" the insurer's experience on all lines of New Jersey business, whether the insurer and its affiliates are reasonably efficient, whether they have allocated expenses to New Jersey in a fair and equitable manner, and the "synergistic effect of mandated private passenger automobile insurance on the sale of other lines of insurance." *N.J.A.C.* 11:3-16.11(d). The regulations leave it to the insurer to devise a "formula it believes

appropriate for determining the return required by relevant constitutional principles, with supporting analysis and date fully explaining why such formula should be utilized." *N.J.A.C.* 11:3-16.11(e). At that point, the Commissioner "may determine whether an insurer's rates are, as a result of the payment of the surtaxes and assessments, constitutionally adequate." *N.J.A.C.* 11:3-16.11(f).

In upholding the facial constitutionality of the anti-pass-through provisions of the Fair Act, the Supreme Court acknowledged "uncertainty" about whether the regulations would enable the Commissioner to "fulfill his duty under the statute to assure that insurers receive a constitutionally fair rate of return." *State Farm, supra,* 124 *N.J.* at 62-63. The concurring opinion went further, expressing "grave doubts about the ability of the Commissioner of Insurance, under present regulations, to guarantee insurance companies a constitutionally-adequate rate of return." 124 *N.J.* at 66-67 (Garibaldi, J., concurring). We do not think the Commissioner has provided meaningful standards.

In this unique situation, however, we decline to reverse and remand for a new hearing to be held after the Commissioner adopts new regulations setting forth more precise standards and methodologies for applications for retrospective rate increases. We are satisfied that State Farm received fair treatment and achieved a fair rate of return for 1990 and 1991, notwithstanding the assessments and surtax. State Farm was permitted to present all pertinent data and to urge any methodology it chose upon the agency. No avenue of argument or theory was foreclosed. This was an unprecedented hearing. No traditional regulatory guidelines were available. Adoption of new regulations would have consumed considerable time and no doubt resulted in controversies similar to those which arose at the hearing and on the appeal here. Indeed, the regulations would probably have been challenged

on appeal to this court. Calculating an insurer's profitability is a complex process best resolved by the agency entrusted with regulating insurance companies. *See State Farm, supra,* 124 *N.J.* at 61. We are satisfied that the parties each had a chance to urge the formula and methodology of its choice upon the ALJ and the agency and that State Farm received a fair hearing on its contentions. In this unique situation the constitution was satisfied.

Remaining is State Farm's claim that the Commissioner deliberately inflated its income and minimized its expenses in order to deny it relief. The argument reflects the sense of hostility and distrust many insurers have expressed toward the former Commissioner, a situation that prior cases have noted leads to a great deal of litigation and an unwillingness to compromise. *See Matter of Commissioner of Insurance, supra,* 132 *N.J.* at 233; *Matter of Aetna Casualty & Surety Co., supra,* 248 *N.J. Super.* at 388.

State Farm is not entirely correct in asserting that the Commissioner ruled against it on every issue. Both the ALJ and the Commissioner accepted State Farm's claim for a $36.2 million UCJF reserve in 1990, over objection by DOI staff. The Commissioner also overruled DOI's objection and agreed with State Farm on the issue of the applicable tax rates. We cannot on this record attribute a deliberate bias on the part of the Commissioner to skew his analysis for the purpose of denying relief to State Farm. On the other hand, the Commissioner did make it difficult for insurers generally to succeed in an as-applied challenge.

The adoption of detailed standards through the rulemaking process in which the regulated industry will have an ample opportunity to participate would go far toward dispelling the sense that the Commissioner has acted or will act in less than a fair and impartial manner. There were some inconsistencies in the Commissioner's meth-

odology. For example, he refused to consider State Farm's substantial AIRE payments, even though they are contained in the excess profits report, because it was speculative whether State Farm would continue to be a net payer in the future. He also ruled that State Farm had to account for unrealized capital gains and losses, items not contained in the excess profits report—not enough to constitutionally flaw the process perhaps, but nonetheless questionable.

For future purposes, the DOI should develop more specific regulations for methods and standards for determining both fair and achieved rates of return retrospectively. Policy making through adjudication, rather than rulemaking, should be avoided when possible. *In re Solid Waste Utility Customer Lists*, 106 *N.J.* 508, 519 (1987); *see Metromedia, Inc. v. Director, Div. of Taxation*, 97 *N.J.* 313 (1984); *Matter of Farmers' Mutual Fire Assurance Association, supra*, 256 *N.J. Super.* 607.

Affirmed.

APPENDIX B

[Filed Sep. 27, 1995]

SUPREME COURT OF NEW JERSEY
C-125 September Term 1995

40,501

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
Plaintiff-Petitioner,
v.

STATE OF NEW JERSEY, SAMUEL FORTUNATO, *et al.*,
Defendants-Respondents.

ON PETITION FOR CERTIFICATION

To the Appellate Division, Superior Court:

A petition for certification of the judgment in A-2042-92 having been submitted to this Court, and the Court having considered the same;

It is ORDERED that the petition for certification is denied, with costs.

WITNESS, the Honorable Robert N. Wilentz, Chief Justice, at Trenton, this 26th day of September, 1995.

/s/ Stephen Townsend
Clerk of the Supreme Court

APPENDIX C

Order No. A92-319

STATE OF NEW JERSEY
DEPARTMENT OF INSURANCE

OAL Docket No.: INS 6227-92

Agency Docket No.: Company 90-610(R) and
90-1056(R)

IN THE MATTER OF THE PRIVATE PASSENGER AUTOMOBILE RATE FILINGS ON BEHALF OF STATE FARM MUTUAL AUTOMOBILE INSURANCE CONCERNING FAIR ACT SURTAXES AND ASSESSMENTS

FINAL DECISION AND ORDER

This matter comes before the Commissioner of Insurance ("Commissioner") pursuant to N.J.S.A. 17:29A-1 et seq., N.J.S.A. 52:14B-1 et seq. and all powers expressed or implied therein.

This matter is a proceeding on remand from the Superior Court of New Jersey, Chancery Division, Mercer County, of two filings by State Farm Mutual Automobile Insurance Company ("State Farm") to increase rates for private passenger automobile insurance to reflect surtaxes and assessments imposed pursuant to the Fair Automobile Insurance Reform Act of 1990, ("the FAIR Act") *N.J.S.A.* 17:33B-1 *et seq.*

On May 11, 1990 State Farm applied for a rate increase of 5% to reflect a 5% surcharge on private passenger auto premiums. This rate filing was initially con-

solidated with State Farm's pending prior approval rate filing and requests for additional information were made by the Department. On August 24, 1990 State Farm applied for a similar rate increase concerning the Property Liability Insurance Guaranty Association ("PLIGA") assessment pursuant to N.J.S.A. 17:30A-8a(9) proposing a 2.7% increase on all auto policies for eight years (DOI Docket #90-1066).

By letter dated October 29, 1990, the Commissioner advised State Farm that the requested rate increase for surtaxes would no longer be consolidated with the prior approval filing but would be considered in a separate proceeding with the requested rate increase for assessments. Additionally, State Farm was advised that regulations would be promulgated shortly and set forth in detail the data that would be required in order to review the surtax and assessment rate requests. State Farm responded to the Commissioner's letter of October 29, 1990 by letter dated December 5, 1990, providing some information and objecting to other data requests. Thereafter, the DOI and State Farm engaged in a series of correspondence by which the DOI requested additional data and State Farm resisted supplying it.

The matter was transmitted to the OAL on June 28, 1991 as the result of a stipulation which required the transmittal of State Farm's surtax and assessment filings to the OAL with information to be provided through discovery. After the transmittal to the OAL, telephone conference was held on August 1, 1991, and counsel were directed to submit pre-hearing memoranda. Hearings were scheduled to commence on February 24, 1992. During a telephone conference on September 25, 1991, a discovery schedule was established with requests to be made by October 9, 1991, and responses to be provided by October 29, 1991. A schedule was also established for expert reports and pre-filed testimony (See Initial Decision at 5).

A discovery dispute arose in which all parties sought to compel more specific answers to interrogatories. The discovery orders were issued on January 2, 1992, with State Farm to respond within 10 days of receipt of the orders and DOI and Rate Counsel to respond after receipt of State Farm's responses. By letter dated January 13, 1992, State Farm filed with the Commissioner of Insurance an interlocutory appeal which was denied by order dated January 23, 1992. In late January, the hearings scheduled to commence in February were adjourned at the request of all counsel, and a new schedule was established with hearings to commence on June 22, 1992.

The parties exchanged some discovery beginning approximately January 31, 1992 and initial and reply expert reports were exchanged in March, 1992 and, April 1992, respectively. The date for pre-filed direct testimony was postponed at the request of State Farm and DOI for settlement negotiations. A settlement agreement providing for withdrawal of State Farm's surtax and assessment filings was submitted by letter dated May 19, 1992. The settlement was approved by Initial Decision-Settlement dated May 29, 1992 (See Initial Decision at 7 and 8).

On May 29, 1992, State Farm instituted a law suit in Superior Court of New Jersey, Chancery Division, Mercer County claiming that the FAIR Act and DOI's regulations specific to rate filings (N.J.A.C. 11:3-16.11) were unconstitutional as applied to State Farm. The remand order was issued on August 6, 1992, which directed the Office of Administrative Law ("OAL") to determine what State Farm's rates of return were for 1990 and 1991, and what a fair rate of return was for each of those two years. If the achieved rate of return was not fair, rate relief was to be ordered. The court also directed that findings be made regarding the reason for the delay in the resolution of the filing. The Department transmitted the remanded matter to the Office of Administrative Law

("OAL") for hearing on August 13, 1992. Six days of hearings were conducted commencing on August 27, 1992 and concluding on September 16, 1992. The matter was heard by Administrative Law Judge Richard McGill ("ALJ"). The record was closed on September 25, 1992. The case was decided on October 9, 1992 and the Initial Decision was filed October 15, 1992. State Farm, the Public Advocate, the Division of Rate Counsel ("Rate Counsel") and DOI staff filed exceptions to the Initial Decision on October 22, 1992. State Farm and the DOI filed responses to the exceptions by October 28, 1992.

DISCUSSION

The major issues raised by the exceptions submitted by the parties are: (1) The ALJ's determination of a fair rate of return for State Farm during 1990 and 1991; (2) The calculation of State Farm's actual rate of return for 1990 and 1991 as defined by the following sub-issues: (A) The ALJ's conclusion that State Farm's data had not been tested for reasonableness; (B) The ALJ's conclusion that State Farm's $36.2 million UCJF reserve in 1990 should not be deducted from losses in calculating profitability; (C) The ALJ's rejection of State Farm's specific New Jersey loss adjustment expenses; (D) The ALJ's exclusion of State Farm's net payments to AIRE; (E) The ALJ's conclusion concerning the calculation of equity in Unearned Premium Reserves; (F) The ALJ's decision on investment income on Policyholder—Supplied Funds; (G) The ALJ's determination that not all of State Farm's auto reserves in 1991 should be used in the calculation of investment income; (H) The ALJ's calculation of tax rates for the purposes of this proceeding; (I) The ALJ's conclusion that he is not recognizing capital gains and losses; and (J) The ALJ's failure to address the issue of whether State Farm failed to establish the specific effect of its payments of FAIR Act surtaxes and assessments. (3) The ALJ's determination as to why this

proceeding was delayed. These issues are discussed below. After independently reviewing the record and the submission of the parties I adopt the ALJ's Initial Decision with the modification listed below.

Before addressing the major issues raised by the exceptions, it is important to reiterate the point addressed by the ALJ (Initial Decision at 11) that this matter differs from an ordinary rate case in several important respects. First, ratemaking is normally prospective in nature. In prospective ratemaking, experience for a recent period is analyzed to determine the adequacy of rates for the future. The approach taken by the parties in this proceeding differs in that rate relief appears to be dependent on what an anticipated adequate rate of return was during two specific past calendar years.

Second, the ALJ states that insurance ratemaking is normally based on certain generally recognized and accepted ratesetting methodologies such as the loss ratio method, which is embodied in N.J.A.C. 11:3-16.10 for prior approval filings and by incorporation in N.J.A.C. 11:3-16.11 for surtax and assessment filings. The mandated approach involves a comparison between what the insurer's rate of return was for 1990 and for 1991 and what a fair rate of return was for each of those years. This is not ordinarily made in automobile insurance ratemaking, and as a result, there does not appear to be any generally recognized and accepted methodology to make this comparison.

The ALJ further states that in view of the lack of a generally recognized and accepted methodology, it is not surprising that the parties have proposed widely disparate methods. The difficulty is that there are myriad ways to make the mandated comparison, and at the same time, there are no particular guidelines or standards for resolving methodological differences between the parties.

Thus, this proceeding involves complexities that are not ordinarily present in a rate case.

Thirdly the ALJ states that, it should be recognized that the regulations, N.J.A.C. 11:3-16.6 through N.J.A.C. 11:3-16.11, set forth detailed data filing requirements. In the remand order, the Court required that "all usual data" be pre-filed. The ALJ notes that data is usually submitted in accordance with N.J.A.C. 11:3-16.6 to 16.10 for prior approval filings and N.J.A.C. 11:3-16.11(a) and (b) for surtax and assessment filings. However, as discussed further below, State Farm did not submit the data required by those regulations but rather relied on its excess profits report, which is unusual for a rate proceeding.

It is important to note that the sole and limited purpose of the Excess Profit Report is to compare actual performance with the performance predicted in State Farm's last approved rate filing in order to determine if an insurer had an excess profit.

I. *What constitutes a fair rate of return*

First, State Farm states that the ALJ found that the constitutional rate of return was an after tax 13% return on equity. State Farm takes exception to the ALJ's rejection of its testimony because State Farm asserts that there was little analysis of objective data. State Farm argues that the ALJ rejected unrefuted evidence simply because the evidence was not capable of being plugged into a formula that could be used in any state (See State Farm exception at 24).

State Farm states that given the tremendous risk associated with New Jersey private passenger automobile insurance it is appropriate and even conservative to use 16% as the appropriate cost of capital (See State Farm's exceptions at 29).

Additionally, State Farm asserts that in establishing the fair rate of return, investors are concerned solely with true expected results, not theoretical results (See State Farm's exceptions at 30).

The DOI took exceptions to the ALJ's conclusion that "the DOI's expert utilized an array of data . . . without identifying a fair rate of return for State Farm" (Initial Decision at 19). DOI asserts that its expert did identify a fair rate of return for State Farm using the comparable risk (See DOI's exception at 2 and 4).

The DOI asserts that State Farm misrepresents the ALJ's conclusions regarding a fair rate of return, by ignoring the distinction between the cost of capital, which is a prospective concept, and a retrospective analysis of achieved rates of return. Additionally, the DOI staff states that the 13% figure used by the ALJ is a number which reflects an expected rate of return (i.e., the rate of return investors may expect, at the beginning of the year, to earn during the subsequent year.) (See DOI's reply to exceptions at 6 and 7).

State Farm states that the DOI's expert did not use the comparable risk methodology to determine the expected cost of capital. State Farm argues that the DOI's expert simply opined that State Farm's actual New Jersey private passenger auto and all lines returns were comparable to country-wide returns for the industry from 1986-1991. State Farm asserts that this is not a fair rate of return analysis and that comparing State Farm's results to an industry average is improper, because the industry may have inadequate or excessive earnings for the period in question (See State Farm's reply to exceptions at 2).

State Farm takes exception to the confidence intervals used by the ALJ. State Farm asserts that the ALJ's intervals do not provide a "range of reasonableness" such that the lower end of the range represents the bare bones

minimum constitutional rate of return (i.e., the absolute minimum rate that will attract investors) (See State Farm's exceptions at 31).

The DOI asserts that the ALJ properly considered statistical data and country-wide industry returns in determining a fair rate of return (See DOI's reply to exceptions at 10).

Finally, State Farm argues that the issue of whether it has been denied a fair rate of return should be determined solely on the actual returns for 1990 and 1991 (See State Farm's reply to exceptions at 13).

I find State Farm's argument unpersuasive. The constitutional adequacy of State Farm's actual returns, in 1990 and 1991 requires an analysis of returns over several years, on all property casualty lines of business written in New Jersey. Therefore, I reject State Farm's argument.

The ALJ appropriately stated the applicable constitutional standards which were recently reviewed by our Supreme Court in *State Farm v. State,* 124 *N.J.* 32(1991). As set forth therein, the landmark case under the United States Constitution is *FPC v. Hope Natural Gas Co.,* 320 U.S. 591, 64 *S.Ct.* 281, 88 L.Ed. 333 (1944), where the United States Supreme Court stated (Initial Decision at 12):

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its

> credit and to attract capital. . . . [Id., 320 U.S. at 603, 64 S.Ct. at 288, 88 L.Ed. at 345.]

The ALJ further noted (Initial Decision at 13) that the New Jersey Supreme Court has accepted the comparable risk method as an appropriate method for use in this jurisdiction. As the New Jersey Supreme Court stated in *State Farm v. State, supra,* 124 *N.J.* at 48:

> . . . to avoid confiscatory results under the taking clause, "the return should be one which is generally commensurate with returns on investments in other enterprises having comparable risks."

The ALJ also cites *Duquesne Light Co. v. Barasch,* 488 *U.S.* 299, 109 *S.Ct.* 609, 102 *L.Ed. 2d* 646 (1989), for stating the point at which rates become confiscatory. The ALJ noted that . . . a wide range of returns can be expected in the insurance industry. Thus, the task in evaluating returns for a given past year is not simply to determine the center of the range of reasonableness but rather to identify the outer bounds of the range of reasonableness (Initial Decision at 13 and 14).

The ALJ correctly stated that:

> The right to a constitutionally adequate rate of return does not generally extend to individual services provided by regulated entities, but rather applies to the enterprise as a whole. In *Fort Smith Light & T. Co. v. Bourland,* 267 *U.S.* 330, 332, 45 *S.Ct.* 249, 69 L.Ed. 631, 633 (1925), the United States Supreme Court held that a street railway company "may be compelled to continue the service of a branch or part of a line, although the operation involves a loss." Further, the city railway company could not abandoned an unprofitable line unless, among other things, "the system, as a whole, was not earning a fair return upon the value of the property used and useful in the business."

Additionally, the ALJ (Initial Decision at 16) notes that courts have recognized that:

> . . . a state may constitutionally require the provider of a vital public service to provide that service to a part of its market, which, standing alone, is profitable. (Citation omitted). [Matter of Plan of Orderly Withdrawal, 248, N.J. Super. 616, 637 (App. Div. 1991), aff'd. 129 N.J. 389 (1992)].

The ALJ concludes that a multi-line insurer's constitutional right to a fair rate of return pertains to the enterprise as a whole as defined by jurisdictional rate-setting and does not extend to each individual line of insurance. Second, multi-line insurers will be treated as a single entity for purposes of achieving the objectives of the FAIR Act (Initial Decision at 16).

I concur with the ALJ that an analysis of a fair rate of return requires several years of data, on an all lines basis, utilizing a comparable risk method as the procedure for analysis. As noted by the ALJ, the constitution does not require approval of rates that guarantee that an insurer will make a profit in all lines for all years. I find that it is appropriate to consider the insurer's experience on all lines of its business for a period of time over which it could plan to earn a reasonable rate of return. A two year span (1990-1991) is not a long enough time period to determine whether an insurer has earned a reasonable rate of return.

I adopt the interim conclusions of the ALJ that 13.0% is an approximation of the center of the range of reasonableness for a fair rate of return on a long term basis for private passenger automobile insurance (Initial Decision at 19). I also adopt the ALJ's finding that returns in the vicinity of –3.6% to 2.6% as the low end of the range of reasonableness a retrospective analysis limited to one year for private passenger automobile insurance (Initial Decision at 20). In considering a short time

frame, such as a single year, it is to be expected that there are a wide range of acceptable results considering the volatility and cyclicality of earnings in the insurance industry.

II. *Calculation of State Farm's achieved rate of return*

In concluding that State Farm did not establish a confiscation of its property that would require rate relief, the ALJ was faced with deciding several sub-issues concerning the calculation of State Farm's rate of return in 1990 and 1991. The disputes among the parties on these sub-issues were thoroughly argued and briefed before the ALJ, and the parties again raised many of these arguments in their exceptions. Although the ALJ's resolution of these sub-issues individually was not critical to his ultimate conclusion, it is appropriate that this decision address them and set forth the items on which I agree and disagree with his findings for the record and for guidance in future cases.

A. *Data Source*

State Farm takes exception with the ALJ's findings that State Farm's data had not been tested for reasonableness and that Rate Counsel and the DOI were under severe time constraints in reviewing the data. State Farm argues that the record does not support this conclusion (See State Farm's exception at 3). DOI took exception to the ALJ's characterization that DOI's expert was not certain as to State Farm's data base (See DOI's exception at 11).

I adopt the ALJ's findings that State Farm's submission in this proceeding on remand has received a different level of scrutiny than would normally occur in a rate proceeding. I am satisfied that the record supports the ALJ's findings of fact.

B. *Exclusion of $36.2 million UCJF Reserve*

The DOI staff takes exception to the ALJ's conclusion that State Farm's $36.2 million UCJF reserve in 1990 should not be deducted from losses in calculating profitability in this proceeding (Initial Decision at 23). This issue involves a reserve (which is calculated as a liability in determining profitability) for PIP medical benefits in excess of $75,000.

The DOI asserts that despite the UCJF law and its intent, State Farm has been advising the DOI for years that it reserves for PIP medical benefits in excess of $75,000 (*i.e.*, establishes a UCJF reserve) and includes this reserve in its excess profits calculations. The DOI states that it has no reason to believe that State Farm is not doing exactly what it says it is. The DOI further states that in answer to a request for clarification of State Farm's discovery responses in this case, State Farm stated that it had a UCJF reserve of approximately $36.2 million in 1990. DOI asserts that based upon this information, its expert witness Dr. Nye deducted that UCJF reserve from incurred losses in calculating State Farm's return for 1990 (See DOI's exception at 25).

The DOI states that although DOI-6 was admitted into evidence early in this proceeding, State Farm never rebutted it or attempted to clarify its discovery response concerning the $36.2 million UCJF reserve set aside in 1990. The DOI states that State Farm's actuarial witness asserted that its calculation in 1990 losses did not include the UCJF reserve. The DOI asserts that State Farm was aware of precisely where and how Dr Nye obtained the information necessary to his calculation of 1990 losses. The DOI argues that rather than explain any error or inconsistency in earlier-provided information, State Farm's witness in this proceeding merely testified that State Farm did not include a $36.2 million UCJF reserve in its 1990 losses. The DOI states that this contradictory information

from State Farm, without any attempt to explain the genesis of the obvious inconsistency, must be rejected and Dr. Nye's calculation of profitability for 1990 must be adopted.

State Farm notes that the ALJ rejected Dr. Nye's original testimony in which he deducted $36.2 million from State Farm's incurred losses which represents the unfunded liability for PIP medical expenses over $75,000. State Farm argues that it did not deduct that amount from incurred losses because under the DOI's methodology for excess profits, these unfunded UCJF liabilities were not included in the incurred losses reported. State Farm further states that Dr. Nye acknowledged that if the $36.2 million was not included as an incurred loss in the excess profits report, his deduction of that amount was an error and should be changed. State Farm argues that the record is clear that State Farm did not include the $36.2 million in its 1990 excess profits reports (See State Farm's reply to exceptions at 31).

State Farm asserts that Dr. Nye made an error by deducting the $36.2 million dollars from incurred losses in 1990. State Farm argues that this sum was not part of the incurred losses because the DOI does not permit it to be included. State Farm further asserts that the $36.2 million should not be deducted from incurred losses since they were not part of those losses in the first instance (See State Farm's reply to exceptions at 32).

For purposes of this proceeding and based upon the information presented, I adopt the ALJ's findings and conclusions on this issue. There is not sufficient evidence to disturb his finding. However, I note that the excess profits report is not well suited for this proceeding and that this issue remains unclear and demonstrates the problems created when an insurer fails to provide clear and detailed information requested in a rate hearing.

C. *Loss Adjustment Expenses*

State Farm takes exception to the ALJ's decision rejecting State Farm's specific New Jersey loss adjustment expenses and instead adopting Rate Counsel's use of a country-wide ratio (Initial Decision at 25). State Farm asserts that the ALJ did so because State Farm did not demonstrate that its ULAE allocation method was subject to any audits or controls. State Farm argues that the ALJ's findings are unsupported in the record, and contrary to fact. Additionally, State Farm argues that the ALJ's findings are arbitrary, capricious and unreasonable. State Farm states that no one questioned the breakdown of ALAE and ULAE until after the hearing concluded (See State Farm's exceptions at 10).

Based on the information received and for the purposes of this proceeding, I adopt the ALJ's conclusion for the calculation of loss adjustment expenses. State Farm has failed to carry the burden of proof with respect to their allocation of unallocated loss adjustment expense to the State of New Jersey. Since the unallocated loss adjustment expense makes up the greatest portion of Loss Adjustment expense, I agree with the ALJ that a country-wide ratio, which is subject to audit and verification, is appropriate.

D. *General and Administrative Expenses*

State Farm takes exception with the ALJ's decision to exclude State Farm's net payments to AIRE. State Farm argues that the ALJ concluded just one year ago that payments should be included in rates. Additionally, State Farm argues that the ALJ did not provide a rationale to justify his decision. State Farm asserts that the ALJ's decision is unsupported by evidence in the record and is arbitrary, capricious and unreasonable and contrary to law (See State Farm's exceptions at 12).

State Farm asserts that net payments to AIRE should be included as an expense for three reasons. First, the excess profits reports requires that net payments to AIRE be included in profitability calculations. Additionally, State Farm asserts that net payments to AIRE are an expense it incurs because of its statutory responsibilities to write private passenger automobile insurance in New Jersey (See State Farm's exceptions at 14).

Secondly, State Farm states that no expert witness justified the exclusion of net payments to AIRE as a matter of policy or practice. Thirdly, State Farm asserts that the primary basis given for not including net payments to AIRE was the Commissioner's decision in the State Farm prior approval case. State Farm argues that the decision only applies to prospective ratemaking and not to an examination of what actually occurred, as in the case of Excess Profits Reports.

The DOI takes exception to State Farm's position that AIRE expenses should be included in this proceeding because they are included in the excess profits report. The DOI notes that historically State Farm has refused to develop AIRE reimbursements to the ultimate as required in the excess profits report. DOI notes in its post hearing brief referenced in the DOI exceptions that the inclusion of AIRE expenses would have very little impact on the final return on equity for 1990 and 1991. DOI also points out that State Farm's actuary stated that the increase in zero threshold bodily injury liability rates will supply State Farm, with relief from AIRE expenses.

I adopt the ALJ's finding that projected AIRE assessments should not be included in the calculation of State Farm's prospective rate needs. The reasons for not including AIRE assessments are: 1) it is too speculative as to whether State Farm would continue to be a net payer; and 2) to permit one insurer to adjust its rates on the basis of AIRE assessments could well distort the industry-wide mechanism.

E. *Equity in Unearned Premium Reserve*

The DOI Staff takes exception to the ALJ's adoption of State Farm's position with respect to the calculation of equity in the unearned premium reserve (Initial Decision at 25). The DOI asserts that its expert's calculation of equity in the unearned premium reserve is a necessary adjustment in converting returns based upon statutory accounting principles ("SAP") to a return based on generally accepted accounting principles ("GAPP").

The DOI's expert's adjustments are necessary as a result of the fact that under SAP, underwriting income is understated because all of the underwriting expenses incurred in a calendar year are included as expenses in the income statement. Under GAAP, however, the portion of the underwriting expenses which are associated with premiums unearned at year-end are not included as expenses in the income statement. The DOI's expert's adjustment to the equity in the unearned premium reserve is necessary to properly "align" earned premiums and expenses in a GAAP-basis profitability analysis (See DOI's exceptions at 18).

State Farm argues that inclusion of this item was inappropriate and that the ALJ's conclusion on this issue was accurate. State Farm's states that the DOI's expert separately included extra income, from changes in the equity in the unearned premiums reserve, in his calculation of State Farm's profitability. State Farm asserts that the Excess Profits Reports do not include this income (even though the DOI believes that New Jersey Excess Profits Report does not recognize this income) (See State Farm exceptions at 26).

State Farm claims that these adjustments are unnecessary, since equivalent adjustments are made in State Farm's excess profits report. However, as previously noted, the sole limited purpose of the Excess Profits Report is to compare actual performance with the perform-

ance predicated in State Farm's last approved rate filing in order to determine if an insurer had an excess profit.

I reject the ALJ's finding and adopt the DOI's position with respect to this matter. The calculation of equity in the unearned premium reserve is a *necessary adjustment* in converting returns based on statutory accounting principles ("SAP") to a return based on generally accepted accounting principles.

The data used by the DOI expert were figures reported by State Farm in its prior approval filing, its Financial Disclosure Report and in discovery provided in this proceeding. All of these data sources are reported on a *SAP* basis and require the GAAP adjustment made by calculating the equity in the unearned premium reserve. This adjustment is necessary because under SAP, underwriting income is understated since all of the underwriting expenses incurred in a calendar year are included as expenses in the income statement. Under GAAP, the portion of the underwriting expenses which are associated with premiums unearned at year-end are *not* included as expenses in the income statement. The adjustment to the equity in the unearned premium reserve is necessary to properly "align" earned premiums and expenses.

F. *Investment Income on Policyholder Supplied Funds*

State Farm takes exception to the ALJ's adoption of Rate Counsel's method as the appropriate treatment of loss adjustment expenses (Initial Decision at 25 and 26). State Farm argues that for the best measure of State Farm's true profitability, it is appropriate to utilize the amount of funds available for investment as calculated in the excess profits report (See State Farm's exceptions at 28).

The DOI staff also takes exception to the ALJ's rejection of the DOI's calculation of investment income attributable to State Farm's New Jersey private passenger busi-

ness. The DOI's exception involves both the methodology used by its expert and the total amount of reserves available for investment in 1991.

I reject the ALJ's finding and adopt the DOI's exception with respect to this matter. The DOI's calculation attributes investment income to New Jersey private passenger automobile lines in direct proportion to State Farm's reserves in New Jersey, as compared to its countrywide reserves. This is a simple and logical approach which results into a fair allocation of investment income to New Jersey policyholders.

The DOI method relies upon figures reported by State Farm in its verified Insurance Expense Exhibit ("IEE"). In the IEE, State Farm has already allocated investment income between surplus and reserves, and between auto and other lines of business. These allocations are not questioned by the DOI because they are included in certified annual financial statements which are among the most credible and reliable pieces of information available from State Farm.

The IEE auto investment figure is multiplied by the ratio of New Jersey reserves to countrywide reserves to obtain the investment income attributable to New Jersey auto policyholders. This simple, logical calculation results in a fair allocation of investment income to New Jersey policyholders. There is no need for further manipulation such as that performed by State Farm and any further manipulation casts doubt upon the reliability of the results.

G. *UCJF Reserve—Investment Income*

The DOI takes exception to the ALJ's determination that not all of State Farm's auto reserves in 1991 should be used in the calculation of investment income (Initial Decision at 26). The DOI staff states that a UCJF reserve of approximately $126.5 million reported on page 14 of State Farm's certified Annual Statement in 1991

should be included in the calculation of investment income, because it is a reserve which pertains to New Jersey policyholders (See DOI's exceptions at 20 and 21).

State Farm argues that the DOI's expert utilized the same methdology as he did for 1990 except he also included as assets available for investment $126.5 million for 1991 (representing the unfunded liability for PIP payments over $75,000). State Farm argues that investment income on policyholder supplied funds represents investment income on funds received from policyholders (i.e., premiums) which are not immediately spent by the company but are placed in reserve accounts.

State Farm asserts that insurers are not permitted either in ratemaking or in excess profits to reflect the unfunded liability for PIP claims exceeding $75,000. State Farm argues that it never collected any premium for these unfunded liabilities and thus, there are no policyholders supplied funds to invest (See State Farm's reply to exceptions at 29).

The ALJ has determined that a UCJF reserve of approximately $126.5 million reported on Page 14 of State Farm's certified Annual Statement in 1991 should not be used in the calculation of investment income. State Farm asserts that insurers are not permitted to reflect the unfunded liability for PIP claims exceeding $75,000 in ratemaking. State Farm also asserts that these unfunded liabilities were *not* created with policyholder supplied funds.

The DOI has taken an exception to the ALJ's determination on this issue. The DOI asserts that this reserve, obviously, bears a relationship to New Jersey policyholders regardless of where the money to establish this reserve come from. Thus, the DOI maintains that New Jersey policyholders are entitled to their share of investment income on that reserve.

For purposes of this decision and based upon the record as created before the ALJ, I reject the ALJ's finding

and adopt the DOI's position for the reasons stated in the exception.

H. *Applicable Tax Rates*

The DOI takes exception to the ALJ's determination that Rate Counsel's calculation of tax rates (11% in 1990 and 19.7% in 1991) are acceptable for the purpose of this proceeding.

The DOI states that its expert used the standard corporate tax rate (34%) with respect to underwrting income (usually a tax credit on underwriting losses) and an assumed investment tax rate based on the make-up of State Farm's investment portfolio. The DOI argues that State Farm never provided a copy of its consolidated tax return so that the other parties could verify that State Farm is actually taxed at a flat 20% alternative minimum tax rate on a consolidated basis. DOI acknowledges the difference between the parties is not of great consequence (See DOI's exceptions at 22 and 23).

In reply State Farm asserts that the DOI's expert conceded that State Farm's actual tax rate should be utilized. State Farm argues that no one seriously questioned tax rates or tax payments from the Annual Statement, since either (State Farm's or Rate Counsels) could be utilized. State Farm further argues that the approach with no merit is the DOI's staff's (See State Farm's reply to exceptions at 30).

Rate Counsel calculated tax rates for 11.0% for 1990 and 19.7% for 1991 from pre-tax income and income taxes as reflected in State Farm's Annual Statements.

State Farm used the alternative minimum tax of 20% which has the effect of reducing the tax shield normally enjoyed by insurance companies as a result of the fact that the tax credit on underwriting losses exceeds the tax obligation on investment income. The DOI expressed

skepticism that a large company like State Farm paid the alternative minimum tax on a consolidated basis.

The DOI in their initial calculations used the standard corporate tax rate (34%) with respect to underwriting income and an assumed investment tax rate based upon the make-up of State Farm's investment portfolio. Additionally, the DOI expert recalculated his returns using the alternative minimum tax, and found the resulting change in overall returns was relatively minimal.

The ALJ recognized that "this issue cannot be resolved because State Farm has not provided a copy of its consolidated tax return to other parties to verify the tax rate." (Initial Decision at 26 and 27). The ALJ adopted Rate Counsel's tax rates and noted that these relatively low tax rates favor State Farm.

For purposes of this proceeding and based upon the information presented, I reject the ALJ's finding and adopt State Farm's position that an alternative minimum tax on 20% should be used. In making this selection, it must be kept in mind that this proceeding differs from a normal rate proceeding in that the parties agreed to look at a retrospective analysis of 1990 and 1991. In the absence of consolidated tax returns, the 20% alternative minimum tax is most appropriate since that is the rate used for underwriting profit.

I. *Unrealized Capital Gains*

The DOI staff takes exception with the ALJ's conclusion that he is "not recognizing unrealized capital gains and losses for purposes of this proceeding" (See Initial Decision at 27).

The DOI argues that this proceeding is attempting to calculate State Farm's profitability results to determine if there has been a constitutional violation. The DOI states that State Farm asserts that the calculation should be limited to the years 1990 and 1991. The DOI asserts

that if the calculations are so limited, as its expert testified, and the ALJ agrees, that State Farm's substantial unrealized capital gains in 1991 (and losses in 1990) should be considered. The DOI further states that even when looking at a longer-term average, the facts in this case reveal that State Farm has enjoyed substantial unrealized capital gains over the last ten years in a systematic pattern unlike that revealed by industry-wide studies. The DOI states that "the gains are the gains," and to ignore them in the context of this proceeding is inappropriate.

The DOI states that its calculations, performed by its economic expert, contain calculations of State Farm's returns both with and without unrealized capital gains and losses. DOI states that regardless of its calculations utilized (*i.e.*, regardless of the other adjustments made by the ALJ or the Commissioner in calculating State Farm's actual returns in 1990 and 1991), the numbers used should be those which *include* unrealized capital gains and losses (See DOI exceptions at 16 and 17).

State Farm states that the ALJ correctly did not include any adjustment for State Farm's 1990-1991 returns based upon unrealized capital gains. State Farm argues that it realizes no income until it sells the stock in question. State Farm further states that corporations generally do not include unrealized capital gains in their annual profit and loss statements. State Farm states that insurers include them in their Annual Statements not as part of their profit and loss but solely to report their assets because of the NAIC's concern over insurer insolvency (See State Farm's reply to exceptions at 25).

I reject the ALJ's finding and adopt the DOI's position with respect to this issue. The evidence showed that State Farm consistently achieves unrealized capital gain which are not reflected in its returns on investments in the absence of considering this factor. The ALJ's statement that unrealized capital gains and losses generally

are not recognized for ratemaking purposes is correct, but the present matter is outside the scope of normal ratemaking and all of State Farm's usual investment returns should be considered. Therefore, I specifically find that unrealized capital gains and losses are appropriate to be considered in the context of these proceedings.

J. *Effects of Surtaxes and Assessments*

The DOI takes exception to the ALJ's decision with respect to the issue of State Farm's failure to establish the specific effect of its payment of FAIR Act Surtaxes and Assessments. The DOI argues that State Farm failed to entirely establish or even attempt to establish that payment of the surtaxes and assessments has denied it an opportunity to obtain a fair rate of return (See DOI's exceptions at 6).

State Farm states that the DOI's arguments are inaccurate. State Farm argues that it has established: (1) that it paid the surtaxes and assessments totalling $18,112,460.69 in 1990 and $23,389,518.30 in 1991; (2) it sought rate relief for those surtaxes and assessments and the DOI never acted on those requests in 1990 or 1991; (3) State Farm's actual rates for 1990 and 1991 were presented with and without the surtaxes and assessments; and (4) the actual rates of return were below the cost of capital or fair rate of return in each of those years (See State Farm's reply to exceptions at 16).

I adopt the DOI's position that State Farm has failed to establish that the payment of surtaxes and assessments has denied it an opportunity to obtain a fair rate of return for 1990 and 1991.

The ALJ's findings and my review of the record supports the conclusion that State Farm earned a fair and adequate rate of return for the years 1990 and 1991. I agree that surtaxes and assessments rate relief requires a showing by the filer that the specific payment of the sur-

taxes and assessment necessitated the need for rate relief. The fact that State Farm earned a fair rate of return for 1990 and 1991 makes the DOI's concern a moot point.

III. *Reasons the Proceeding was delayed*

State Farm takes exception to the ALJ's finding that the delays through October 20, 1990 were the DOI's responsibility but were excusable but that the delays after October 29, 1990 were primarily attributable to State Farm's resistance to discovery. State Farm asserts that these conclusions ignore unrefuted evidence in the record and are arbitrary, capricious and unreasonable (See State Farms exceptions at 38).

The DOI asserts that the ALJ's reasons for delay in processing State Farm's pass-through rate requests reveals a complete understanding and command of the relevant facts. (See DOI's reply to exceptions at 13).

Upon review of the record I defer to the ALJ's familiarity with the facts and adopt the ALJ's conclusion.

For the above reasons

IT IS on this 17th of November, 1992

ORDERED that the Initial Decision rendered on October 19, 1992, is adopted as modified above, as my Final Decision and that rate relief is denied.

Date: 11/17/92

/s/ Samuel F. Fortunato
SAMUEL F. FORTUNATO
Commissioner

APPENDIX D

[State Seal]

STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW

OAL Dkt. No. INS 6227-92
Agency Dkt. Nos. 90-610(R) and 90-1056(R)

IN THE MATTER OF THE PRIVATE PASSENGER AUTOMOBILE RATE FILINGS ON BEHALF OF STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY CONCERNING FAIR ACT SURTAXES AND ASSESSMENTS.

INITIAL DECISION

Record Closed: September 25, 1992

Decided: October 9, 1992

BEFORE RICHARD McGILL, ALJ:

This matter is a proceeding on remand from the Superior Court of New Jersey, Chancery Division, Mercer County, of two filings by State Farm Mutual Automobile Insurance Company (State Farm) to increase rates for private passenger automobile insurance to reflect surtaxes and assessments imposed pursuant to the Fair Automobile Insurance Reform Act of 1990, *L.* 1990, c. 8 (the FAIR Act).

The remand order states in pertinent part as follows:

> [State Farm's] filings regarding the effect of its 1990 surtax and assessment expenditures on its rate of return, are remanded to the Office of Administrative

> Law which is directed to promptly make the determinations required by this court; in doing so, it shall control any additional minimal discovery which any party may seek so a hearing may be held and a decision forwarded to the Commissioner of Insurance and this Court by September 30, 1992.

The determinations required by the Court were set forth in a written memorandum as follows:

> The ALJ assigned should require all *usual* data to be pre-filed, on an expedited basis, and then he should determine what the insurer's rate of return was for 1990 and for 1991 and what a fair rate of return was for each of those years. If the achieved rate was not fair, then he should adjust the rates accordingly, for collection in whatever manner he deems reasonable. Depending on the final action at the administrative level [6], the matter can be reviewed either by this Court or the Appellate Division or both.

In footnote 6, the memorandum provides as follows:

> The ALJ should examine the reasons for the delay in processing the pending pass-through filing and explain whether it is usual or unusual for the process to permit the filing to be still undecided.

PROCEDURAL HISTORY

The remand order was issued on August 6, 1992, and the matter was transmitted to the Office of Administrative Law (OAL) on August 13, 1992, by the Department of Insurance (DOI) for determination as a contested case pursuant to *N.J.S.A.* 52:14F-1 to -13. A prehearing conference was held by telephone on Auust 17, 1992, and an expedited schedule was established. In accordance with the schedule, State Farm pre-filed expert reports on August 25, 1992, and DOI and the Public Advocate, Division of Rate Counsel (Rate Counsel) filed initial reports

and/or testimony on August 26, 1992. Six days of hearings commenced on August 27, 1992 and concluded on September 16, 1992. Briefs were due September 22, 1992, and the record was closed on September 25, 1992, after an oral argument. The date for filing the Initial Decision was extended to October 9, 1992.

REASONS FOR DELAY

The reasons for delay will be considered first in order to set forth the procedural history of the surtax and assessment filings and otherwise place the dispute in its proper context. These proceedings span a period of time from May 11, 1990 until the present. This entire period can be evaluated through consideration of several shorter intervals.

In regard to the first interval, I FIND as follows. The FAIR Act was enacted on March 12, 1990. By letter dated May 11, 1990, State Farm requested approval of a rate increase of 5.0 percent applicable to private passenger automobile insurance in New Jersey to reflect surtaxes imposed by the FAIR Act. DOI advised State Farm by letter dated June 15, 1990, that this request was consolidated with State Farm's pending prior approval filing. By letter dated August 24, 1990, State Farm requested approval of a 2.7 percent increase in rates applicable to private passenger automobile insurance in New Jersey to reflect assessments imposed by the FAIR Act. By letter dated October 29, 1990, the Commissioner of Insurance advised State Farm that the requested rate increase for surtaxes would no longer be consolidated with the prior approval filing but would be considered in a separate proceeding with the requested rate increase for assessments. Additionally, the Commissioner advised State Farm that regulations would be promulgated shortly and set forth in detail the data that would be required in order to review the surtax and assessment rate requests. The regulations for surtax and assessment rate filings were adopted

on an emergency basis on November 26, 1990 and were formally adopted on January 25, 1991.

During the period of time from May 11, 1990 until October 29, 1990, State Farm was unaware of the filing requirements and could not proceed with its cases. The lack of progress during this period of time must be attributed to DOI. However, during this time, DOI was attempting to implement the FAIR Act, which is a major reform of automobile insurance. This delay seems reasonable under the circumstances.

The next pertinent period of time began with the Commissioner's letter of October 29, 1990. With respect to this second interval, I FIND as follows. State Farm responded by letter dated December 5, 1990, providing some information and objecting to other data requests. The letter states that some data requests are legally irrelevant or otherwise objectionable and that the requests are invalid as a violation of due process because of a lack of standards. State Farm enclosed over 270 pages of data nearly all of which were already on file with the DOI. By letter dated December 13, 1990, DOI responded that the filing was not complete and specified the information which State Farm had failed to provide. State Farm responded by letter dated January 3, 1991 but provided little additional information and requested that the matter be transferred to the OAL. By letter dated January 28, 1991, DOI responded to State Farm and again advised that the surtax and assessment filings were incomplete and outlined additional information that was required. State Farm responded by letter dated February 13, 1991, requesting that the matter be transmitted to the OAL and indicating that it had provided the information which was currently available and that additional information was being collected and would be forwarded. By letter dated March 20, 1991, State Farm provided additional information and again requested that the matter be transmitted

to the OAL. During the hearings in this proceeding, Assistant Commissioner Martin Rosenberg summarized the information which was still not provided as follows:

> In particular, State Farm had, by March 20, 1991, still not provided to the Department an itemization of its specific expenses in New Jersey. In addition, State Farm had not provided any description of its expense allocation methodologies other than by reference to NAIC Regulation 30. Regulation 30 is a lengthy narrative which contains suggestions and methodologies for the allocation of expenses. There is no specific formula set forth in Regulation 30 and its application by one insurer may be very different from its application by another insurer. The Department sought to understand exactly how State Farm allocates expenses to its private passenger automobile insurance line, and other lines, in New Jersey. Regulation 30, itself, requires the insurer to maintain and make available for examination records showing the methods and effects of the insurer's expense allocation. Therefore, the Department continued to seek more specific information on the expense allocation methodology used by State Farm. These particular concerns were again set forth in my letter of April 11, 1991 to State Farm's attorney. With that letter, I enclosed a suggested format for providing the information in hopes that a response might be expedited.

State Farm did not respond to the letter of April 11, 1991, as it had already filed an appeal with the Appellate Division of Superior Court on April 2, 1991. The appeal was dismissed on June 19, 1991, as the result of a stipulation which required the transmittal of State Farm's surtax and assessment filings to the OAL with information to be provided through discovery. The matter was transmitted to the OAL on June 28, 1991.

This second interval ended with the transmittal to the OAL. State Farm maintains that the data requests were burdensome and required information that is not kept in the ordinary course of business. DOI states that it can normally obtain additional information fairly quickly from a rate filer and that it is unusual for a rate filing to remain incomplete for six months.

To some extent, all concerned were dealing with a new situation which caused some uncertainty. However, it is clear that State Farm resisted DOI's efforts to obtain information to some degree. The time required by State Farm seems excessive, as all the underlying information necessary to respond was presumably within State Farm's control. State Farm simply had to exert the effort to collect the information and organize it as required by the regulation, which is presumptively valid. State Farm has not established that its resistance was justified in any way. Thus, this delay can be attributed to uncertainty caused by the new filing requirements and to State Farm's resistance thereto.

A third interval began with the transmittal to the OAL, and I FIND as follows. At the OAL, a telephone conference was held on August 1, 1991, and counsel were directed to submit pre-hearing memoranda. Hearings were scheduled to commence on February 24, 1992. During a telephone conference on September 25, 1991, a discovery schedule was established with requests to be made by October 9, 1991, and responses to be provided by October 29, 1991. A schedule was also established for expert reports and pre-filed testimony.

A discovery dispute arose in which all parties sought to compel more specific answers to interrogatories. DOI's motion to compel State Farm to provide more specific answers to interrogatories was granted. Rate Counsel's motion to compel more specific answers was granted in part and denied in part. State Farm's motion to compel

more specific answers to interrogatories was granted in part and denied in larger part. To the extent that the motion was granted, State Farm requested the positions of DOI and Rate Counsel on various issues. These requests were not answered to some extent because State Farm's responses to discovery requests were necessary in order to formulate those positions. The discovery orders were issued on January 2, 1992, with State Farm to respond within 10 days of receipt of the orders and DOI and Rate Counsel to respond after receipt of State Farm's responses. Another order, which was also issued on January 2, 1992, will be discussed below. By letter dated January 13, 1992, State Farm filed with the Commissioner of Insurance an interlocutory appeal which was denied by order dated January 23, 1992. In late January, the hearings scheduled to commence in February were adjourned at the request of all counsel, and a new schedule was established with hearings to commence on June 22, 1992.

The discovery dispute was the primary cause of delay during this period of time, as it necessitated an adjournment of the hearing from February to June 1992. With respect to DOI's request for more specific answer to interrogatories, State Farm's position largely lacked merit, and in fact, it is fair to say that State Farm resisted discovery which was central to the proceeding. Rate Counsel's requests were excessive, and some relief was granted. To the extent that State Farm's requests for more specific answers to interrogatories were granted, this relief was actually a reflection of the fact that State Farm had not responded to discovery that was needed by the other parties to formulate their positions. Thus, the discovery dispute centered around State Farm's failure to provide answers to interrogatories. It must be said that the degree of resistance to discovery by State Farm is unusual, as a party seeking a rate increase normally makes an effort to have the case brought to hearing at the earliest pos-

sible date. When the discovery orders were issued on January 2, 1992, State Farm did not simply comply with those orders but rather compounded matters by taking an interlocutory appeal. Realistically, there does not appear to be any reason to think that the interlocutory appeal of the discovery orders would be successful. However, it was readily foreseeable that any delay in responding to the discovery requests would necessitate an adjournment of the hearings. In fact, the hearings scheduled for February 1992 were adjourned, and after the adjournment, State Farm provided answers to interrogatories. In retrospect, it appears that the hearings could very well have commenced in February 1992, if State Farm had simply provided its responses a few weeks earlier rather than resist discovery to an unusual degree. Thus, the conclusion is warranted that State Farm was primarily responsible for the delay during this period of time.

Another consideration is that to a large extent, DOI's discovery requested the same information that DOI had sought for many months. One interrogatory concerned key performance indicators and is identical to a data requirement which is specified in the Commissioner's letter dated October 29, 1990 and included in the regulations at *N.J.A.C.* 11:3-16.11(b)5. State Farm had provided data for one year, while the letter, the regulation and the interrogatory called for data for three years. Other interrogatories requested information concerning expense allocations and the synergistic effect of the mandated sale of private passenger automobile insurance on the sale of other lines of insurance. The interrogatories request essentially the same information as is required by the Commissioner's letter of October 29, 1990 and the regulations. Thus, State Farm knew in late October or early November 1990, that it was required to file this information, and yet it did not do so until the beginning of 1992, when ordered to do so.

State Farm's lengthy delay of approximately one year and three months before providing the data appears to be grossly excessive. To my experience, large corporations can respond to extensive discovery requests within a matter of weeks when motivated by a desire for a rate increase. A period of one or two months may reasonably be expected to be more than ample. Under the circumstances, the burden is properly placed upon State Farm to explain the lengthy delay.

State Farm's witness generally attributes the length of time to respond to the burdensomeness of the data requirements including a claim that the data was not kept in the ordinary course of business. Having reviewed State Farm's presentation in regard to the issue of delay, I cannot find anything that would justify the failure to provide portions of the original data filing requirements one year and three months after being advised thereof. Under the circumstances, the conclusion is warranted that State Farm's lengthy delay in providing this information was unjustified, inexcusable and the primary cause of delay in this proceeding from October 1990 to January 1992.

A fourth interval began approximately January 31, 1992, and I FIND as follows. From this point forward, the case seemed to move smoothly. The parties exchanged discovery, and initial and reply expert reports were exchanged in March 1992 and April 1992, respectively. Pre-filed direct testimony was due May 1, 1992, and pre-filed rebuttal testimony was due May 22, 1992. The date for pre-filed direct testimony was postponed at the request of State Farm and DOI for settlement negotiations. A settlement agreement providing for withdrawal of State Farm's surtax and assessment filings was submitted by letter dated May 19, 1992. The settlement was approved by Initial Decision-Settlement dated May 29, 1992.

On that same date, State Farm instituted a law suit in the Chancery Division of Superior Court claiming that

the FAIR Act and the DOI regulations concerning surtaxes and assessments were unconstitutional as applied to State Farm. Allstate Insurance Company filed a similar law suit in the Chancery Division on the same day. As a result of the proceedings in those law suits, State Farm's surtax and assessment filings were remanded to the Office of Administrative Law on August 6, 1992.

Based upon subsequent proceedings in this case, it appears that State Farm is asserting that its withdrawal of the surtax and assessment filings was necessitated by a ruling earlier in the proceeding. On October 11, 1991, DOI filed a motion seeking an order "to preclude State Farm's introduction and/or use of any 1990 profitability data in this rate proceeding." State Farm had expressed its intent in a letter dated October 3, 1991, to present actual results for 1990 not in regard to any issue of prospective ratemaking, but rather to determine what specifically occurred in that past period. In its response to the motion, State Farm made clear that the purpose of the 1990 data was to form a basis for an as-applied challenge to the constitutionality of the FAIR Act. Since the matter transmitted to the OAL was an administrative rate proceeding under *N.J.A.C.* 11:3-16.11 and since ratemaking is prospective in nature, DOI's motion was granted by order dated January 2, 1992. Apparently, State Farm is contending that this ruling precluded recovery of surtaxes and assessments for 1990 and 1991. For the following reasons, this ruling was not cause for State Farm to withdraw the filings.

First, State Farm misinterpreted this ruling, which simply excluded evidence which cannot properly be presented in a rate proceeding. Since I made this ruling, I am in a position to say categorically that in my view this order did not in any sense preclude State Farm from recovery of surtaxes and assessments for 1990 and 1991 in the proceeding under *N.J.A.C.* 11:3-16.11.

In support of its contention that it could present profitability data for 1990, State Farm relied upon the follow-

ing language from *State Farm v. State*, 124 *N.J.* 32 (1991):

> Any arguments based upon actual profits or losses of particular insurers for 1990 would be more appropriately asserted in administrative ratemaking proceedings or as part of an as-applied challenge to the Act. [*Id.* at 62.]

It must be recognized that the proceeding transmitted to the OAL was an administrative rate proceeding as opposed to an as-applied challenge to the FAIR Act. It seems highly unlikely that by this language the Court intended to overturn decades of precedent or otherwise fundamentally change ratemaking. Rather, the above-quoted language simply means that State Farm could present its actual experience for 1990 in an administrative rate proceeding in the manner in which that data is normally presented for ratemaking purposes. This language does not hint at a retrospective analysis or any other deviation for normal ratemaking practices. Moreover, the order dated January 2, 1992 permitted State Farm to present actual profits and losses for 1990 as that data would be utilized under *N.J.A.C.* 11:3-16.11(d)1. The type of analysis envisioned by State Farm may have a place in an as-applied challenge to constitutionality as described in *Troy Hills Village v. Parsippany-Troy Hills Tp. Council*, 68 *N.J.* 604 (1975), but it is simply alien to a normal administrative rate proceeding. State Farm's attempt to build a record for an as-applied challenge was premature, as our Supreme Court clearly envisioned that determinations on individual insurers' rate-increase applications would be rendered before challenges to the constitutionality of the application of the statute or regulation are brought. *State Farm v. State*, 124 *N.J.* at 63.

Second, surtaxes and assessments could certainly be recovered within the context of prospective ratemaking, if the case has merit. Standard ratemaking techniques such as an amortization or some type of deferred accounting

treatment could be utilized. Thus, it is certainly possible to recover surtaxes and assessments for 1990 and 1991 within the context of prospective ratemaking under *N.J.A.C.* 11:3-16.11.

Third, even if State Farm were correct about the effect of the ruling, State Farm would still have ample reason to proceed with its filings. In State Farm's view, there were two parts to its case. One part involved recoupment of the surtaxes and assessments for 1990 and 1991, and the other concerned prospective rate relief for future surtaxes and assessments. It seems readily apparent that the two parts are separate and distinct, and that an adverse ruling with respect to the first part was no reason to withdraw the second part. The amount of potential rate relief associated with the second part was substantial, as surtaxes for 1992 equal approximately $12 million and assessments equal approximately $6 million per year for five years subsequent to 1991. Moreover, it was not necessary for State Fram to withdraw its surtax and assessment filings to initiate its as-applied challenge. Allstate initiated a similar suit without withdrawal of its pending surtax and assessment filings. Under the circumstances, State Farm has not presented any logical reason for withdrawal of its surtax and assessment filings. In fact, the withdrawal in itself was a cause of delay. Certainly, State Farm is solely responsible for the delay caused by the withdrawal of its filings.

In retrospect, it appears that State Farm could have had its case brought to hearing in February 1992, if it genuinely wanted a hearing. Instead, State Farm resisted discovery to an unusual degree and largely without merit, thereby causing an adjournment of the hearings. State Farm certainly could have had its case heard in June 1992, if it genuinely wanted a hearing, but instead State Farm withdrew its filings. State Farm has not given any logical explanation for its actions. Under the circumstances, it is difficult to resist the conclusion that State Farm did not genuinely want a hearing on its surtax and

assessment filings. The logical explanation for State Farm's action is that State Farm's strategy and overriding objective was to obtain relief based on an as-applied challenge to the constitutionality of the FAIR Act. In *State Farm v. State,* 124 *N.J.* at 62, the Court stated: "Further, the rate application process of *N.J.A.C.* 11:3-16.11 by its very complexity may carry the potential for frustrating in practice the achievement of a fair rate of return." It appears that State Farm was trying harder to make those words prophetic than to have its request to recover surtaxes and assessments heard and decided.

To summarize, an initial delay occurred while DOI developed filing requirements for requests for rate increases to recover surtaxes and assessments. Thereafter, State Farm resisted requests for information by DOI prior to transmittal to the OAL, and after transmittal to the OAL, State Farm resisted discovery to an unusual degree, necessitating an adjournment of the hearings scheduled for February 1992. While at the OAL, DOI and Rate Counsel proceeded with unusual and remarkable swiftness for an administrative proceeding. As the hearing dates in June 1992 approached, State Farm took the highly unusual action of withdrawing its surtax and assessment filings. While it is unusual for an insurance rate filing to take this long to decide, the conclusion is warranted that State Farm is primarily responsible for the delay which occurred.

OVERVIEW

This proceeding stems from State Farm's as-applied challenge to the FAIR Act in the Chancery Division of Superior Court. As a result of that proceeding, the Court remanded State Farm's surtax and assessment filings to the OAL to make certain specific determinations including State Farm's fair rate of return for 1990 and 1991 and State Farm's achieved rate of return for 1990 and 1991. The parties have interpreted the remand order to require a retrospective analysis of 1990 and 1991.

This approach differs from an ordinary rate case in several important respects. First, ratemaking is normally prospective in nature. *Petition of Elizabethtown Water Co.*, 107 *N.J.* 440 (1987). In prospective ratemaking, experience for a recent period is analyzed to determine the adequacy of rates for the future. The approach taken by the parties in this proceeding differs in that rate relief appears to be dependent on a loss or insufficient profits during specific past calendar years.

Second, insurance ratemaking is normally based on certain generally recognized and accepted ratesetting methodologies such as the loss ratio method, which is embodied in *N.J.A.C.* 11:3-16.10 for prior approval filings and by incorporation in *N.J.A.C.* 11:3-16.11 for surtax and assessment filings. The mandated approach involves a comparison that is not ordinarily made in automobile insurance ratemaking in this jurisdiction, and as a result, there does not appear to be any generally recognized and accepted methodology to make this comparison.

In view of the lack of a generally recognized and accepted methodology, it is not surprising that the parties have proposed widely disparate methods. The difficulty is that there are myriad ways to make the mandated comparison, and at the same time, there are no particular guidelines or standards for resolving methodological differences between the parties. Thus, this proceeding involves complexities that are not ordinarily present in a rate case.

Third, it should be recognized that the regulations, *N.J.A.C.* 11:3-16.6 through *N.J.A.C.* 11:3-16.11, set forth detailed data filing requirements. In the remand order, the Court required that "all *usual* data" be prefiled. Data are usually submitted in accordance with *N.J.A.C.* 11:3-16.6 to -16.10 for prior approval filings and *N.J.A.C.* 11:3-16.11(a) and (b) for surtax and assessment filings. However, as discussed further below,

State Farm did not submit the data required by those regulations but rather relied on its excess profits report, which is unusual for a rate proceeding.

In accordance with the remand order, the other parties were limited to "minimal discovery." Evidently as a result of the unusual data and the minimal discovery, DOI's expert seemed uncertain as late as the end of the hearing as to what was contained in State Farm's figures. Because of the lack of the usual data for 1990 and 1991 and the limitation on discovery, it appears that State Farm's results for 1990 and 1991 have not been fully evaluated for reasonableness. Ratemaking normally involves an assessment of reasonableness both in an ordinary rate case, *Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 216 (1950) and in an as-applied challenge to constitutionality as well. *Troy Hills Village v. Parsippany-Troy Hills Tp. Council*, 68 *N.J.* at 621-630. It is fair to say that State Farm's submission in this proceeding on remand has received much less scrutiny than would normally occur in a rate proceeding.

Finally, it should be emphasized that the mandated approach is fundamentally different from the standards contained in *N.J.A.C.* 11:3-16.11 for surtax and assessment filings. The standards contained in *N.J.A.C.* 11:3-16.11 were intended to provide closer scrutiny for reasonableness than occurs in a prior approval proceeding under *N.J.A.C.* 11:3-16.10. However, it is clear that this did not occur, as the proceeding was limited to the specific determinations required in the remand order.

FAIR RATE OF RETURN

The constitutional standards to be applied to rate regulation were recently reviewed by our Supreme Court in *State Farm v. State*, 124 *N.J.* 32 (1991). As set forth therein, the landmark case under the United States Constitution is *FPC v. Hope Natural Gas Co.*, 320 *U.S.* 591,

64 *S.Ct.* 281, 88 *L.Ed.* 333 (1944), where the United States Supreme Court stated:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. . . . [*Id.*, 320 *U.S.* at 603, 64 *S.Ct.* at 288, 88 *L.Ed.* at 345.]

Two widely accepted methodologies are based on this language. Methodologies based on the last sentence attempt to determine the cost of capital, typically by estimating the investor's required or expected return. A second approach is based on the next to last sentence and is known as the comparable risk method. This approach is based on the return for investments with corresponding risks.

The New Jersey Supreme Court has accepted the comparable risk method as an appropriate method for use in this jurisdiction. As the New Jersey Supreme Court stated in *State Farm v. State, supra*, 124 *N.J.* at 48:

> . . . to avoid confiscatory results under the takings clause, "the return should be one which is generally commensurate with returns on investments in other enterprises having comparable risks." [Citation omitted.]

In *Duquesne Light Co. v. Barasch*, 488 *U.S.* 299, 109 *S.Ct.* 609, 102 *L.Ed.* 2d 646 (1989), the United States Supreme Court discussed the point at which rates become confiscatory as follows:

> The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so "unjust" as to be confiscatory. *Covington & Lexington Turnpike Road Co. v. Sandford*, 164 *US* 578, 597, 41 *L Ed* 560, 17 *S Ct* 198 (1986) (A rate is too low if it is "so unjust as to detroy the value of [the] property for all purposes for which it was acquired," and in so doing "practically deprive[s] the owner of property without due process of law"); *FPC v. Natural Gas Pipeline Co.*, 315 *US* 575, 585, 86 *L Ed* 1037, 62 *S Ct* 736 (1942) ("By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense"); *FPC v. Texaco Inc.*, 417 *US* 380, 391-392, 41 *L Ed* 2d 141, 94 *S Ct* 2315 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level"). If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments. [*Id.*, 488 *U.S.* at 307-308.]

As this language implies, the fair rate of return is a range of reasonableness. *Id.*, 488 *U.S.* at 312, 109 *S.Ct.* 609, 102 *L.Ed.* 2d at 660.

As pointed out by several witnesses in this proceeding, a wide range of returns can be expected in the insurance industry. Thus, the task in evaluating returns for a given past year is not simply to determine the center of the range of reasonableness but rather to identify the outer bounds of the range of reasonableness.

Ratemaking involves a balancing of investor and consumer interests. *State Farm v. State*, 124 *N.J.* at 49; *FPC v. Hope Natural Gas Co.*, 320 *U.S.* at 603, 64 *S.Ct.* at 288, 88 *L.Ed.* at 345. In setting rates, no particular

methodology is required, but rather a rate order must be evaluated on the end result. *FPC v. Hope Natural Gas Co.*, 320 *U.S.* at 603, 64 *S.Ct.* at 288, 88 *L.Ed.* at 345. A direct pass-through of particular expenses is not required. *Duquesne Light Co. v. Barasch*, 488 *U.S.* at 315, 109 *S.Ct.* 609, 102 *L.Ed.* 2d at 662; *State Farm v. State*, 124 *N.J.* at 63.

Further, the right to a constitutionally adequate rate of return does not generally extend to individual services provided by regulated entities, but rather applies to the enterprise as a whole. In *Fort Smith Light & T. Co. v. Bourland*, 267 *U.S.* 330, 332, 45 *S.Ct.* 249, 69 *L.Ed.* 631, 633 (1925), the United States Supreme Court held that a street railway company "may be compelled to continue the service of a branch or part of a line, although the operation involves a loss." Further, the city railway company could not abandon an unprofitable line unless, among other things, "the system, as a whole, was not earning a fair return upon the value of the property used and useful in the business." *Ibid.*

In *Baltimore & Ohio R.R. Co. v. United States*, 345 *U.S.* 146, 73 *S.Ct.* 592, 97 *L.Ed.* 912 (1953), the Court dismissed the railroad's claim that rates established for the carrying of a particular commodity (vegetables) were confiscatory. In dismissing the railroad's Fifth Amendment "taking" claim, the Court held:

> So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use "without just compensation." [*Id.*, 97 *L.Ed.* at 915].

As to the railroad's due process claim, the Court held:

> And so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for

> carrying some commodities when the public interest is thereby served. [*Id.*, 97 *L.Ed.* at 316].

State Farm relies on an earlier case, *Brooks-Scanlon Co. v. Railroad Commission of Louisiana,* 251 *U.S.* 396, 40 *S.Ct.* 183, 64 *L.Ed.* 323 (1920), for the proposition that a carrier cannot be compelled to spend profits from one line of business to support another line of business. State Farm's reliance is misplaced. In *Matter of Valuation Proceedings Under* §§ 303(c) & 306, 439 *F.Supp.* 1351, 1357, n. 12 (1977), the Court stated:

> Although some transferors quote Justice Holmes' earlier statement [in *Brooks-Scanlon*]:
>
> > A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage.
>
> it is clear that the portion of the sentence preceding the comma is not the law. *See Fort Smith Light & Traction Co. v. Bourland,* 267 *U.S.* 330, 45 *S.Ct.* 249, 69 *L.Ed.* 631 (1925) (Mr. Justice Brandeis writing for a unanimous Court). *Cf. Baltimore & Ohio R.R. Co. v. United States,* 345 *U.S.* 146, 73 *S.Ct.* 592, 97 *L.Ed.* 912 (1953).

State Farm also relies on *Troy Hills Village v. Parsippany-Troy Hills Tp. Council,* 68 *N.J.* 604 (1975) for the proposition that one apartment complex cannot subsidize another in the context of rent control. In that case, the Court set out a detailed methodology including a requirement that each individually administered apartment complex should be treated separately. State Farm's reliance on this rent control case is misplaced for two reasons. First, the Court expressly stated that the details of the methodology are not constitutionally required; and second, the Court specifically distinguished rent control cases from rate-fixing cases. *Id.*, at 622.

Most compellingly, in the insurance context, our courts have recognized that:

> . . . a state may constitutionally require the provider of a vital public service to provide that service to a part of its market, which, standing alone, is not profitable. (Citation omitted). [*Matter of Plan for Orderly Withdrawal,* 248 *N.J. Super.* 616, 637 (App. Div. 1991), aff'd, 129 *N.J.* 389 (1992)].

The New Jersey Supreme Court employed even stronger language in response to the argument made by Twin City that the Commissioner had no authority to treat Twin City and its affiliates as a single entity. Twin City involved § 72 of the FAIR Act which permits the Commissioner to terminate an insurer's license to conduct all property/casualty business in New Jersey if the insurer withdraws from the business of writing private passenger automobile insurance. *N.J.S.A.* 17:33B-30. In this regard, the New Jersey Supreme Court stated:

> Twin City's interrelationship with its affiliates is indisputably sufficient to justify a regulatory approach that treats them pragmatically as a single entity.
>
> * * *
>
> Whether Twin City and its affiliates operate as divisions of a single corporation or as subsidiary corporations of an integrated insurance holding company, a responsible regulator could hardly ignore their common ownership and operational interdependence. [*Twin City,* 129 *N.J.* at 409]

Several conclusions can be drawn from the above. First, a multi-line insurer's constitutional right to a fair rate of return pertains to the enterprise as a whole as defined by jurisdictional ratesetting and does not extend to each individual line of insurance. Second, multi-line insurers will be treated as a single entity for purposes of achieving the objectives of the FAIR Act. An example illustrates the potential unfairness that could be caused by applying constitutional standards to one line of insurance. In the situation where an insurer with 10 lines of

insurance is achieving a fair rate of return, or even an excessive rate of return, on all-lines basis, the insurer seeks a rate increase for one line which standing alone is not achieving a fair rate of return. In seeking meticulous fairness from its own perspective, the insurer overlooks the fact that ratesetting involves a balancing of investor and consumer interests. It is unsupported to suggest that a rate increase is constitutionally required under these circumstances.

This is not to say that rates cannot be set for an individual line of insurance. Prior to the FAIR Act, rates for private passenger automobile insurance and other lines apparently were set exclusively on a single line basis. *N.J.S.A.* 17:29A-4. With rates for each line set to allow a fair rate of return on that type of insurance, presumably the entire enterprise would have the opportunity to achieve a fair rate of return. However, this approach is not constitutionally required. The point is that in view of the above, a multi-line insurer cannot prove that rates are confiscatory on the basis of returns for an individual line of insurance. Rather, the insurer must show that investors who invested in the entire enterprise had their property confiscated. This proof requires an all-lines analysis.

This conclusion is supported by the rate regulation of public utilities, where a revenue requirement is determined for all jurisdictional services and the individual rates are adjusted to produce the revenue requirement. The fair rate of return is applied to the rate base for the entire company with ratesetting for individual services based on policy considerations as well as cost data. *Public Service Coordinated Transport v. State*, 5 *N.J.* 196 (1950).

The presentations of the parties concerning the fair rate of return may be considered with these principles in mind. State Farm determined the fair rate of return by

estimating its cost of capital for 1990 and 1991 in the context of information and expectations that existed at that time. While State Farm as a mutual company does not attract capital in the market, all parties seem to agree that for purposes of this proceeding, State Farm may be treated the same as an investor-owned insurance company. State Farm's experts estimated the investor-required rate of return to be in the range of 16 percent to 23 percent. For purposes of its calculation, State Farm utilized a fair rate of return of 16 percent.

Rate Counsel's expert witness on the rate of return estimated that the prospective cost of capital for State Farm is approximately 12.5 percent to 13.0 percent. However, Rate Counsel's expert expressed the view that earnings in a particular year cannot be compared to the fair rate of return, but rather earnings over a period of time should be compared to the fair rate of return.

Rate Counsel's actuarial expert developed a method to compare actual returns for a given year to the fair rate of return. Using a statistical method, he developed a 90 percent confidence interval around the fair rate of return. This technique indicated that the range of reasonableness for the fair rate of return on a retrospective basis was 2.6 percent to 18.8 percent.

DOI's expert witness took a somewhat different approach and reviewed actual rates of return from 1986 to 1991 published in NAIC's *Report on Profitability By Line By State* and also industry returns published by the Insurance Services Office and Value Line. DOI's expert also expressed the view that one cannot form an opinion regarding the adequacy of rates of return by looking solely at one or two years of returns because equity investments are typically considered long-term investments. As to returns in a given year, DOI's witness stated as follows:

> One cannot form an opinion regarding the adequacy of returns by looking solely at one or two years of return. Equity investments are typically considered

long-term investments. For example, economists (and investors) expect equity investments to provide returns on average that are greater than returns enjoyed from fixed income (e.g., bonds) investments because equity investments are generally more risky than fixed income investments.

Ibbotson and Associates have measured returns earned on stocks and bonds for the period from 1926 to 1991. Their results are not surprising; stocks do in fact enjoy higher returns than bonds *on average*, about 8.6% greater than returns on one-month Treasury bills. However, there were many years in which stock returns were less than bond returns and even some years when stock returns were negative. Thus, expectations about investment returns are based on long-term realizations and not on realized returns from one or two years.

An individual company, or the whole stock market for that matter, may realize negative returns or returns much less than expected in any given year. However, that fact does not necessarily indicate that the company earned something less than a "fair" rate of return over that period. If other firms of comparable risk also earned lower than expected returns, then the disappointing results may have been due to general economic conditions and a "low" return may be the "fair" return. Moreover, an individual company may experience unexpectedly low or high returns due to its unique circumstances. Only by looking at profitability results over a several-year period can one determine whether a company is or is not earning adequate returns for its investors.

DOI's expert utilized an array of data including countrywide returns for automobile insurers and property/casualty insurers without identifying a fair rate of return for State Farm. Instead, DOI's expert constructed a confidence interval around State Farm's 16 percent rate of

return. For an actual six-year average result, the range would be 8.0 percent to 24.0 percent. For an actual one-year result, the range would be from -3.6 percent to 35.6 percent.

State Farm's witnesses estimated the cost of capital to be in the range of 16 percent to 23 percent, based on the premise that automobile insurance is an investment with above-average risk. DOI and Rate Counsel criticized this presentation as lacking support in the form of detailed analysis of quantitative data. This criticism appears to be well taken, as the testimony is long on general discussion with little analysis of objective data.

Rate Counsel's witness concluded that automobile insurance is an investment with average risk and concluded that the fair rate of return is approximately 12.5 percent to 13.0 percent. State Farm criticizes Rate Counsel's estimated cost of capital, because it does not reflect the risks associated with automobile insurance in New Jersey. Further, State Farm maintains that confidence intervals have never been used before.

The cost of capital is based on the investors' expected or required return. The required return as used in rate-setting is typically an average return with the full expectation that actual returns in particular years will vary from the average but that in the long term, actual returns will approach the average. Based upon the presentation of the parties and taking into account the criticisms thereof, the conclusion is warranted that the investors' long-term expected or required return is in the area of 13.0 percent. This figure is an approximation of the center of the range of reasonableness for the fair rate of return.

DOI and Rate Counsel have developed techniques to determine the ends on the range of reasonableness in a retrospective analysis. Rate Counsel estimated a range of reasonableness for retrospective returns from 2.6 percent

to 18.8 percent, while DOI developed a range from -3.6 percent to 35.6 percent. State Farm opposes use of a confidence interval around the long-term average expected return.

Obviously, an insurer cannot expect to achieve an average return each year considering the volatility and cyclicality of earnings in the insurance industry. Under the circumstances, a range of reasonableness is necessary for a retrospective analysis of returns in the insurance industry. Based upon the presentations of DOI and Rate Counsel, I accept returns in the vicinity of -3.6 percent to 2.6 percent as the low end of the range of reasonableness for a retrospective analysis of one year.

This conclusion is confirmed by a comparable risk analysis of returns for private passenger automobile insurance. For 1990, the actual return on a countrywide basis was 4.8 percent. Surely, the average return countrywide is within the range of reasonableness for that particular year.

As a final caveat, it should be observed that these figures do not represent a constitutional minimum. As noted above, a single line of insurance provided by a multi-line insurer may be required to operate at a loss consistent with constitutional requirements.

ACHIEVED RATE OF RETURN

The positions of the parties with respect to the achieved rate of return are summarized as follows. State Farm based its analysis on its experience in private passenger automobile insurance only, and as a data base, State Farm used its excess profits report. State Farm concluded that its achieved rates of return for 1990 and 1991 excluding surtaxes and assessments were -0.1 percent and 9.1 percent, respectively. With surtaxes and assessments included, the achieved rates of return for 1990 and 1991 were -12.0 percent and -3.5 percent, respectively.

Rate Counsel's approach is similar to State Farm's method in that Rate Counsel's analysis was limited to private passenger automobile insurance. As data bases, Rate Counsel used State Farm's Annual Statements for 1990 and 1991 and some data from the excess profit report. Rate Counsel calculated achieved rates of return for 1990 and 1991 including surtaxes and assessments to be 3.4 percent and 7.5 percent, respectively. The corresponding figures for the achieved rates of return excluding surtaxes and assessments are 12.7 percent for 1990 and 16.4 percent for 1991.

Taking a somewhat different approach, DOI analyzed State Farm's performance on the basis of private passenger automobile insurance standing alone and on an all-lines basis. DOI used as data bases State Farm's filing, State Farm's Annual Statements for 1990 and 1991, and to a very large extent the NAIC Report on Profitability By Line By State. DOI's witness concluded that for private passenger automobile insurance standing alone, State Farm's achieved rates of return for 1990 and 1991 including surtaxes and assessments were 21.5 percent and 8.4 percent, respectively. If unrealized capital gains are included, the achieved rates of return would be 18.9 for 1990 and 18.5 percent for 1991. From DOI's exhibits, it appears that each figure would be approximately 8 percent higher with surtaxes and assessments excluded.

Several observations are in order before addressing the specific issues concerning the achieved rate of return. First, as noted above with respect to the fair rate of return, the constitutionally protected right to a fair rate of return applies to the enterprise as a whole. Therefore, a multi-line insurer cannot prove that it was denied the constitutional right to a fair rate of return on the basis of results for one line of insurance.

Second, the type of delving into details to determine reasonableness that normally occurs in a rate proceeding took place in this proceeding only to a limited extent. The

issues largely concern the contents of the data and the proper method for a retrospective analysis. The lack of inquiry into reasonableness is cause for concern considering that reasonableness is always the issue in a rate proceeding. This is particularly true under *N.J.A.C.* 11:3-16.11, as the standards seemed to contemplate closer scrutiny for reasonableness than would normally occur in an ordinary rate case. Evidently, the parties interpreted a sentence in the memorandum attached to the remand order stating that "there is no judicial nor legislative direction to make any other consideration than is made in an ordinary rate-increase filing. . ." to mean that *N.J.A.C.* 11:3-16.11 is effectively stripped of those provisions which require closer scrutiny for reasonableness than would occur in a prior approval filing. Prior to State Farm's withdrawal of the surtax and assessment filings in May 1992, DOI submitted a number of expert reports directed to the question of reasonableness, but several of those witnesses did not testify in the proceeding on remand.

A related consideration concerns the data bases relied upon by the parties. The remand order required that all usual data be pre-filed, while State Farm actually submitted its excess profit report. As set forth below, DOI's expert was uncertain as late as the end of the hearing whether a major item, $36.2 million related to the Unsatisfied Claim and Judgment Fund (UCJF), was included in State Farm's losses as contained in the excess profit report. It is cause for concern that DOI's expert was not certain as to the contents of the data base in a major proceeding, and it is an indication that something is seriously amiss.* The concern relates not so much to errors that have been detected, but rather the possibility that something may have been overlooked.

*** This statement is in no way a criticism of DOI's expert or the other experts, as they all made extraordinary efforts under severe time constraints.**

Data for prior approval are normally submitted in accordance with *N.J.A.C.* 11:3-16.6 to *N.J.A.C.* 11:3-16.10, and data for surtax and assessment filings are normally submitted in accordance with *N.J.A.C.* 11:3-16-11. While it is true that these regulations require data for trending losses, expenses and so on, into the future that are not needed for purposes of a retrospective analysis, the fact remains that these data are the usual data for rate filings. State Farm's choice of the excess profit report is highly unusual for a rate proceeding and, in fact, caused confusion because DOI's out-of-state expert was not familiar with that particular report. Given the unusual nature of the data and the limitation to "minimal discovery" as provided by the remand order, it is doubtful that the data have been properly scrutinized for reasonableness.

A final concern is the lack of a recognized methodology and the absence of any standards for a retrospective analysis. Two competing approaches are to apply rate-making treatment as closely as possible or to reflect actual performance for 1990 and 1991 in an economically realistic manner. Since this proceeding is in the final analysis a rate case, it is appropriate to apply the rate-making treatment whenever reasonable and appropriate.

Premiums

One component of the determination to be made herein is the level of premium for 1990 and 1991. The parties appear to be in substantial agreement as to this component. State Farm and Rate Counsel used the same figures, which should be utilized in this proceeding.

Losses

With respect to losses, DOI's expert deducted $36.2 million from State Farm's losses for 1990 to reflect the fact that State Farm has established a reserve for future payments to the UCJF. State Farm maintains that this amount was not included in the losses contained in the

excess profits report and that therefore the deduction is unwarranted.

State Farm's witness seemed certain that the amount of $36.2 million for the UCJF reserve was not included in the losses reported in the excess profits report, and Rate Counsel's witness, who seemed to be more familiar with the excess profits report, did not make this adjustment. DOI's expert inferred from other data that this figure was included in the losses for 1990. Under the circumstances, I accept State Farm's position on this issue.

Loss Adjustment Expenses

For loss adjustment expenses, State Farm utilized New Jersey specific data from its excess profits report, and DOI took a similar approach. Rate Counsel did not utilize the New Jersey specific loss adjustment expenses but rather multiplied New Jersey losses by a ratio of countrywide loss adjustment expenses to countrywide losses to estimate New Jersey loss adjustment expenses. Rate Counsel made this adjustment because State Farm reported much higher loss adjustment expense ratios in its excess profits report for New Jersey than on a countrywide basis as derived from its Annual Statement. Rate Counsel maintains that the higher level of loss adjustment expenses is unjustified and that under the circumstances, it is more appropriate to use the countrywide ratio which is subject to audit and verification.

State Farm responds that the relationship of loss adjustment expenses to losses will vary widely among the states. State Farm's witness compared the New Jersey ratio to the countrywide ratio during each of the last five years and determined that in each of those years the New Jersey ratio for both liability and physical damage coverages was higher than the countrywide ratio. State Farm attributes the differential to differences in states' tort systems and their complexities, the legal expenses incurred in adjusting claims, differences in salaries for claims ad-

justers and other employees in settling claims, and vehicle storage costs among others. In addition, a claimant is much more likely to be represented by an attorney in New Jersey.

Rate Counsel responds that losses per automobile in New Jersey are among the highest in the country, and that therefore higher loss adjustment expenses in New Jersey relative to the countrywide data do not explain the higher ratio of loss adjustment expenses to losses. In addition, loss adjustment expenses are composed of allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE), which are the greater part. In 1990, ALAE were $11.5 million, while ULAE were $29.3 million. In 1991, ALAE were $3.9 million, and ULAE were $42.8 million. Rate Counsel argues that State Farm had to use some method to allocate ULAE to New Jersey automobile insurance and that State Farm has not shown that the allocation method is subject to any audits, controls or checks as are the allocations in the Annual Statement, from which Rate Counsel derived its data.

Rate Counsel's argument is persuasive that the fact that loss adjustment expenses are higher in New Jersey than countrywide does not fully explain the higher ratio in New Jersey. In addition, State Farm has not explained the allocation of ULAE, which make up the larger part of loss adjustment expenses, to New Jersey automobile insurance. While New Jersey specific data was utilized in State Farm's last prior approval filing, the issue involves an evaluation of the reasonableness of particular expense data rather than conceptual differences. Under the circumstances, State Farm has failed to carry the burden of proof, and I accept Rate Counsel's position on this issue.

General and Administrative Services

State Farm included in its expenses for general and administrative services net payments to the Automobile Insurance Risk Exchange (AIRE) in 1990 and 1991. AIRE assesses or reimburses private passenger automobile insurers to prevent inequities that could result from the dual tort threshold. In support of its position, State Farm argues that it has been a net payer to AIRE in every year of its existence since 1984. Net AIRE payments are included in the excess profits report which is a retrospective look at profitability. DOI and Rate Counsel oppose inclusion of net AIRE payments because the Commissioner of Insurance does not recognize them for ratemaking purposes.

While I recommended in State Farm's last prior approval filing that State Farm's net payments to AIRE should be reflected in rates and while State Farm's argument seems somewhat stronger in this case in that uncertainty as to future payments is not a consideration, the fact remains that the Commissioner of Insurance has specifically rejected the view that assessments and reimbursements by AIRE should be reflected in rates. *In re State Farm,* Dept. of Insurance Order No. A91-197 (May 3, 1991). Under the circumstances, I accept the Commissioner's determination as the appropriate ratemaking treatment. Therefore, the position of DOI and Rate Counsel with respect to net AIRE payments should be approved.

Equity in Unearned Premium Reserve

DOI's expert included extra income from changes in the equity in the unearned premium reserve in his calculation of State Farm's profitability based on the belief that the excess profit report does not recognize this income. State Farm's witness testified that this income is included in the excess profits report, and Rate Counsel did not make the DOI adjustment. In fact, DOI appears to have abandoned this position.

The witnesses for State Farm and Rate Counsel seemed to be more familiar with the excess profits report, and State Farm's witness stated that the income is included in the excess profits report, while Rate Counsel did not make an adjustment for this income. Under the circumstances, State Farm's position should be accepted.

Investment Income on Policyholder-Supplied Funds

State Farm and Rate Counsel calculated the amount of investment income on policyholder-supplied funds by first identifying the amount of assets available and then multiplying by a yield rate. The assets available for investment include reserves for losses, loss adjustment expenses and unearned premium. Rate Counsel's approach to the amount of assets differs in that Rate Counsel uses a level of loss adjustment expenses as discussed and approved above. Rate Counsel utilized slightly higher yield rates, specifically, 6.9 percent for 1990 and 6.7 percent for 1991, compared to State Farm's yield of 7.2 percent for 1990 and 6.6 percent for 1991.

Taking an entirely different approach, DOI's witness allocated a portion of State Farm's countrywide investment income to New Jersey based on the ratio of New Jersey reserves to countrywide reserves. State Farm maintains that the total investment income was overstated because it includes investment income from Canadian operations and net investment income from reinsurance. In response, DOI submitted revised schedules eliminating these items.

Additionally, State Farm contends that DOI's witness overstated New Jersey reserves for 1991 by including as assets available for investment $126.5 million representing an unfunded liability for personal injury protection (PIP) payments over $75,000. State Farm maintains that it has established a reserve for this amount, but that it has not collected this amount in premiums and therefore the amount does not represent policyholder-supplied funds.

Evidently, State Farm established this reserve based upon its own business judgment. However, the amount does not represent policyholder-supplied funds, since the underlying losses have never been reflected in rates. Therefore, this method does not fairly estimate investment income from policyholder-supplied funds for 1991.

While the methods utilized by State Farm and Rate Counsel were similar, Rate Counsel's method reflects the treatment of loss adjustment expenses approved herein. Rate Counsel's method is reasonable and should be approved.

Tax Rates

DOI's witness initially used the standard corporate tax rate of 34 percent with respect to underwriting income and an assumed investment tax rate based upon State Farm's investment portfolio. State Farm claims that the alternative minimum tax of 20 percent was used in its 1990 federal income tax. DOI's witness expressed skepticism that a large company like State Farm actually paid the alternative minimum tax on a consolidated tax basis. Nonetheless, DOI's witness provided a calculation of returns using the alternative minimum tax. This issue cannot be resolved because State Farm has not provided a copy of its consolidated tax return to the other parties to verify the tax rate.

Rate Counsel calculated tax rates of 11.0 percent for 1990 and 19.7 percent for 1991 from pre-tax income and income taxes as reflected in State Farm's Annual Statements. Those tax rates are acceptable for purposes of this proceeding. It may be noted that these relatively low tax rates favor State Farm.

Conversion to Return on Equity

State Farm is the only party which briefed the conversion of after-tax operating profit to return on equity. The three steps in the conversion from after-tax operating

profit to return on equity are first to multiply the after-tax operating profit by the premium-to-surplus ratio, then to add the investment income on surplus, and finally to divide by the ratio of equity using generally accepted accounting principles to surplus calculated using statutory accounting principles. DOI and Rate Counsel are directed to address this conversion in their exceptions.

Unrealized Capital Gains

In 1990, State Farm experienced an unrealized capital loss of $507 million, and in 1991, State Farm had an unrealized capital gain of $2,226 million. The effect of recognition of these unrealized capital gains and losses would be to decrease the achieved return by approximately 2 percent in 1990 and to increase the achieved return by approximately 10 percent in 1991.

Unrealized capital gains and losses generally are not recognized for ratemaking purposes because they tend to offset one another over a period of time and because of their unpredictability on a prospective basis. Generally, the risks and benefits associated with fluctuations in the portfolio are allocated to the investor rather than the policyholder. Therefore, consistent with the ratemaking treatment, I am not recognizing unrealized capital gains and losses for purposes of this proceeding. On the other hand, if emphasis is to be placed on State Farm's actual experience in 1990 and 1991, these unrealized capital gains could well be considered.

Unquantified Issues

During the course of the hearings, issues were raised concerning whether State Farm over-reserves thereby inflating losses and whether State Farm was slow to implement permitted rate increases such as flex rate changes, thereby decreasing premium. Those issues are noted but will not be discussed, as the parties did not propose any quantitative adjustments to the achieved rates of return.

Interim Conclusion

Before considering issues related to other lines and other years as raised by DOI, it is appropriate to assess the effect of the issues treated above as they define the scope of the proceeding as viewed by State Farm and Rate Counsel. In view of the treatment of those issues, I have in effect adopted Rate Counsel's overall position, and therefore, I accept the following as the achieved rates of return: excluding surtaxes and assessments the achieved rates of return were 12.7 percent in 1990 and 16.4 percent in 1991, and including surtaxes and assessments, the achieved rates of return were 3.4 percent in 1990 and 7.5 percent in 1991.

With respect to the achieved rates of return of 12.7 percent for 1990 and 16.4 percent for 1991 excluding surtaxes and assessments, these returns are within the range of reasonableness and average slightly above the mid-point. The achieved rates of return of 3.4 percent in 1990 and 7.5 percent in 1991 including surtaxes and assessments are also within the range of reasonableness for realized returns in specific years. It is particularly noteworthy that the average of these returns is higher than the achieved rate of return of 4.8 percent for country-wide private passenger automobile insurance. In regard to the mid-point of the range of reasonableness, an insurer obviously cannot expect to achieve a rate of return equal to or above the long-term average return in each and every year. Achieved returns below the mid-point in some years are to be expected.

The above assessment is based on State Farm's and Rate Counsel's approach which reflects an interpretation of *N.J.A.C.* 11:3-16.11 that effectively reduces the regulation to a point where it is equivalent to a prior approval proceeding under *N.J.A.C.* 11:3-16.10. Under the circumstances, the question that must be raised is whether this approach amounts to a direct passthrough which would be prohibited by *N.J.S.A.* 17:33B-51 for surtaxes and by

N.J.S.A. 17:30A-16b for assessments, as there does not appear to be any difference at the quantitative level.

Other Lines and Other Years

DOI made an attempt to apply *N.J.A.C.* 11:3-16.11 partially by presenting data for all of State Farm's lines of business and over a period of time. With surtaxes and assessments included as presented in Exhibit D attached to DOI-10, which is the most similar to the disposition of the issues herein, the achieved rate of return on an all-lines basis averaged 1.7 percent higher than for New Jersey private passenger insurance standing alone. The average rate of return for New Jersey private passenger automobile insurance from 1986 to 1991 was 4.35 percent higher than the corresponding average rate of return for 1990 and 1991. Thus, it is fair to say that consideration of other lines and other years would lead to the conclusion that State Farm's achieved rate of return was closer to the center of the range of reasonableness.

Conclusion

Based upon all of the above, the conclusion is warranted that State Farm has not established a need for rate relief based upon its actual experience in 1990 and 1991.

Accordingly, it is ORDERED that:

1. State Farm's request for rate relief is denied.
2. The matter be forwarded to the Commissioner of Insurance for consideration with a copy of the Initial Decision sent to the Chancery Division of Superior Court in Mercer County.

I hereby FILE my Initial Decision with the COMMISSIONER OF THE DEPARTMENT OF INSURANCE for consideration.

This recommended decision may be adopted, modified or rejected by the COMMISSIONER OF THE DEPART-

MENT OF INSURANCE, who by law is authorized to make a final decision in this matter. If the Commissioner of the Department of Insurance does not adopt, modify or reject this decision within forty-five (45) days and unless such time limit is otherwise extended, this recommended decision shall become a final decision in accordance with *N.J.S.A.* 52:14B-10.

Within thirteen (13) days from the date on which this recommended decision was mailed to the parties, any party may file written exceptions with the ASSISTANT COMMISSIONER OF THE DEPARTMENT OF INSURANCE, 20 West State Street, CN 325, Trenton, New Jersey 08625, marked "Attention: Exceptions." A copy of any exceptions must be sent to the judge and to the other parties.

Oct. 9, 1992 — /s/ Richard McGill
Date — RICHARD MCGILL, ALJ

Receipt Acknowledged:

Oct. 14, 1992 — /s/ Linda A. Wallace
Date — Department of Insurance

Mailed to Parties:

Office of Administrative Law

APPENDIX

WITNESS LIST:

For State Farm:

Steven G. Lehmann
Gary K. Ransom
Irving H. Plotkin

For Department of Insurance:

Martin Rosenberg
Blaine F. Nye
Brian P. Sullivan

For Rate Counsel:

Allan I. Schwartz
David C. Parcell
Michael J. Ileo

EXHIBIT LIST

SF-1	Schedule entitled "State Farm's Accident Year Results Excluding Surtax and PLIGA Assessments"	Evidence
SF-2	Schedule entitled "State Farm's Accident Year Results Including Surtax and PLIGA Assessments"	Evidence
SF-3	Schedule entitled "State Farm's Calendar Year Results Excluding Surtax and PLIGA Assessments"	Evidence
SF-4	Schedule entitled "State Farm's Calendar Year Results Including Surtax and PLIGA Assessments"	Evidence
SF-5	Schedule entitled "Earned Premium	Evidence
SF-6	Schedule entitled "Incurred Losses and Loss Adjustment Expenses—Accident Year Basis"	Evidence
SF-7	General and Administrative Expenses Excluding Surtax and PLIGA Assessments"	Evidence
SF-8	Schedule entitled "Investment Income on Policyholder Supplied Funds"	Evidence

EXHIBIT LIST

SF-9	Schedule entitled "After Tax Operating Profit or Loss Accident Year Basis Excluding Surtax and PLIGA Assessments"	Evidence
SF-10	Schedule entitled "After Tax Investment Income on Surplus"	Evidence
SF-11	Schedule entitled "Approximate Conversion From SAP Surplus to GAAP Equity"	Evidence
SF-12	Schedule entitled "General and Administrative Expenses Including Surtax and PLIGA Assessments"	Evidence
SF-13	Scheduled entitled "After Tax Operating Profit or Loss Accident Year Basis Including Surtax and PLIGA Assessments"	Evidence
SF-14	Schedule entitled "Incurred Losses and Loss Adjustment Expenses Calendar Year Basis"	Evidence
SF-15	Schedule entitled "After Tax Operating Profit or Loss Calendar Year Basis Excluding Surtax and PLIGA Assessments"	Evidence
SF-16	Schedule entitled "After Tax Operating Profit or Loss Calendar Year Basis Including Surtax and PLIGA Assessments"	Evidence
SF-17	Schedule entitled "Returns on Equity Property—Casualty Insurance vs Utilities"	Evidence
SF-18	Schedule entitled "State Farm's New Jersey Written Premium Growth"	Evidence
SF-19	Schedule entitled "Premium Adjustment Needed Due to Surtax and PLIGA Assessments"	Evidence
SF-20	Resume of Steven G. Lehmann	Evidence
SF-21	Report of Steven G. Lehmann dated March 1992	Evidence
SF-22	Rebuttal report of Steven G. Lehmann dated April 1992	Evidence
SF-23	Report of Steven G. Lehmann dated August 25, 1992	Evidence

EXHIBIT LIST

SF-24	Report of Gary K. Ransom	Identification
SF-25	Rebuttal report of Gary K. Ransom dated April 16, 1992	Identification
SF-26	Report of Gary K. Ransom dated August 25, 1992	Evidence
SF-27	Report of Irving H. Plotkin dated March 1992	Evidence
SF-28	Report of Irving H. Plotkin dated April 1992	Evidence
SF-29	Report of Irving H. Plotkin dated August 1992	Evidence
SF-30	Report of Richard E. Stewart dated March 1992	Identification
SF-31	Rebuttal report of Richard E. Stewart dated April 1992	Identification
SF-32	Report of Richard E. Stewart dated August 1992	Evidence
SF-33	Certification of Thomas P. Weidner dated June 26, 1992 with 22 attachments	Evidence
SF-34	Certification of Thomas P. Weidner dated July 30, 1992 with five attachments	Evidence
SF-35	Certification of Thomas P. Weidner dated July 20, 1992 with five attachments	Evidence
SF-36	Certification of Steven G. Lehmann dated June 26, 1992 with four attachments	Evidence
SF-37	Letter dated December 5, 1990 from Thomas P. Weidner to the Honorable Samuel F. Fortunato	Evidence
SF-38	Letter dated November 12, 1991 from Thomas P. Weidner to Honorable Richard McGill	Evidence
SF-39	Letter dated November 21, 1991 from Marilyn S. Silvia to Honorable Richard McGill, ALJ	Evidence
SF-40	Two discovery orders in *In re State Farm, OAL Dkt. No. INS 6497-91, Agency DKt. Nos. 90-610 and 90-1056,* dated January 2, 1992	Evidence

EXHIBIT LIST

SF-41	Excess profits report for New Jersey Private Passenger Auto	Evidence
SF-42	Excerpt from transcript of testimony of Allan I. Schwartz	Evidence
SF-43	Excerpt of direct testimony of David C. Parcell dated September 30, 1991 in *In re Selective Insurance Company of America, OAL Dkt. No. INS 5302-91, Agency Dkt. No. 91-0460*	Evidence
SF-44	Excerpt of direct testimony and schedules of Michael J. Ileo and David C. Parcell dated September 17, 1990 in *In re Workers Compensation Insurance Rates in Commonwealth of Virginia*	Evidence
SF-45	Certification of Steven G. Lehmann dated July 17, 1992	Evidence
SF-46	Order to Show Cause dated July 19, 1990 against State Farm Insurance Companies	Evidence
SF-47	Letter dated August 10, 1990 from Thomas P. Weidner to Arthur M. Keefe	Evidence
SF-48	Letter dated August 29, 1990 from Samual F. Fortunato, Commissioner to Steven G. Lehmann	Evidence
SF-49	Letter dated September 24, 1990 from Deborah T. Poritz to Samuel F. Fortunato, Commissioner	Evidence
SF-50	Letter dated September 25, 1990 from Martin Rosenberg to Martin R. Brown	Evidence
SF-51	Letter dated October 9, 1990 from Thomas P. Weidner to Martin Rosenberg	Evidence
SF-52	Letter dated June 29, 1990 from Martin R. Brown to the Honorable Samuel Fortunato	Evidence
SF-53	Excerpt from defendant's brief in Chancery Division proceeding, *State Farm v. State of New Jersey, et al.*	Evidence
SF-54	Supplemental certification of Martin Rosenberg dated May 30, 1990	Evidence

EXHIBIT LIST

SF-55	Report entitled "Level of Competition in the California Private Passenger Automobile Insurance Market" by Robert H. Litzenberger and Blaine F. Nye	Evidence
SF-56	Report entitled "An Economic Analysis of the California Insurance Initiatives" dated October 5, 1988 by Alfred E. Hofflander, Blaine F. Nye and Beth Charlesworth	Evidence
SF-57	Rebuttal report of Irving H. Plotkin dated September 9, 1992	Evidence
SF-58	Rebuttal testimony of Steven G. Lehmann dated September 9, 1992	Evidence
SF-59	Schedule entitled "State Farm Recalculation of Nye Returns"	Evidence
SF-60	Excerpt of pre-filed direct testimony of Allan I. Schwartz in proceeding before Texas Department of Insurance	Evidence
SF-61	Excerpt of pre-filed testimony of Allan I. Schwartz dated October 23, 1991 before the Department of Insurance of the State of North Carolina	Evidence
SF-62	Rebuttal testimony of Gary K. Ransom dated September 9, 1992	Evidence
SF-63	Rebuttal testimony of Richard E. Stewart dated September 9, 1992	Evidence
SF-64	Letter dated March 20, 1991 from Thomas P. Weidner to Martin Rosenberg with attachments	Evidence
SF-65	Letter dated October 3, 1991 Thomas P. Weidner to the Honorable Richard McGill	Evidence
SF-66	Letter dated November 27, 1991 from Thomas P. Weidner to the Honorable Richard McGill	Evidence
SF-67	Request for Interlocutory Review of OAL Discovery Orders and Memorandum in Support Thereof	Evidence
SF-68	Certification of Steven G. Lehmann dated July 30, 1992	Evidence

EXHIBIT LIST

SF-69A	Letter dated February 10, 1992 from Steven G. Lehmann to the Honorable Samuel F. Fortunato	Evidence
SF-69B	Letter dated February 18, 1992 from Steven G. Lehmann to the Honorable Samuel F. Fortunato	Evidence
SF-70	Letter dated February 18, 1992 from Martin Rosenberg to Steven G. Lehmann	Evidence
DOI-1	Direct testimony of Martin Rosenberg dated August 1992	Evidence
DOI-2	Direct testimony of Blaine F. Nye, Ph.D. dated August 1992	Evidence
DOI-3	NAIC Report on Profitability by Line by State 1990 dated November 1991	Evidence
DOI-4	Report of Insurance Services Office, Inc. entitled "Long Term Profitability: The Risk—Return Tradeoff"	Evidence
DOI-5	Excerpt from report dated July 10, 1992 entitled "Insurance (Property/ Casualty)"	Evidence
DOI-6	Discovery response entitled "Revised Exhibit 2"	Evidence
DOI-7	Supplemental direct testimony of Martin Rosenberg dated September 4, 1992	Evidence
DOI-8	Chart of insurance rate proceedings	Evidence
DOI-9	No exhibit	Evidence
DOI-10	Rebuttal report of Blaine F. Nye, Ph.D., dated September 1992	Evidence
DOI-11	No exhibit	Evidence
DOI-12	Rebuttal report of Brian P. Sullivan, Ph.D. dated September 1992	Evidence
DOI-13	Rebuttal testimony of Martin Rosenberg dated September 9, 1992	Evidence
DOI-14	Exhibits to brief in support of State defendants' motion to dismiss, Volume 1	Evidence
DOI-15	Exhibits to brief in support the State defendants' motion to dismiss, Volume 2	Evidence

EXHIBIT LIST

DOI-16	Certification of Martin Rosenberg dated July 13, 1992	Evidence
DOI-17	Certification of William Rader dated July 28, 1992	Identification
DOI-18	Certification of Marilyn S. Silvia dated July 30, 1992	Evidence
DOI-19	Letter dated September 11, 1992 from Maryann Kralik to Martin R. Brown	Identification
DOI-20	List of flex rate filers	Evidence
DOI-21	List of flex rate filings	Evidence
DOI-22	List of flex rate filings from July 1, 1991 to June 30, 1993	Evidence
DOI-23	List of standard/nonstandard rate filings	Evidence
DOI-24	List of private passenger auto zero threshold increases 1990-present	Evidence
DOI-25	Schedules entitled "Exhibit B"	Evidence
DOI-26	Schedules entitled "Exhibit C"	Evidence
DOI-27	Schedules entitled "Exhibit D"	Evidence
DOI-28	Schedule entitled "Exhibit D" revised to include net AIRE in 1990 and 1991	Evidence
DOI-29	Schedule entitled "Exhibit D" revised to include net AIRE in 1990 and 1991 without surtaxes and assessments	Evidence
RC-1	Direct testimony of Allan I. Schwartz dated August 26, 1992 with cover letter	Evidence
RC-2	Report of Insurance Services Office, Inc. entitled "Long Term Profitability: Risk-Return Tradeoff"	Evidence
RC-3	Report of Insurance Services Office, Inc. entitled "Insurer Financial Results: 1991"	Evidence
RC-4	Direct testimony of David C. Parcell dated August 26, 1992	Evidence
RC-5	Reply report of Technical Associates, Inc. dated April 15, 1992	Identification
RC-6	Schedule entitled "Five-year Historical Data"	Evidence
RC-7	Schedule entitled "Five-year Historical Data"	Evidence

EXHIBIT LIST

RC-8	Schedule entitled "Liabilities, Surplus and Other Funds"	Evidence
RC-9	Rebuttal report of Allan I. Schwartz dated September 9, 1992	Evidence
RC-10	Rebuttal testimony and exhibits of Michael J. Ileo	Evidence
RC-11	Rebuttal testimony and exhibits of David C. Parcell	Evidence
J-1	Article entitled "Economic Objectives of Regulation—The Trend in Virginia" by Michael J. Ileo and David C. Parcell	Evidence

APPENDIX E

[Filed Aug. 6, 1992]

SUPERIOR COURT OF NEW JERSEY
CHANCERY DIVISION-MERCER COUNTY
GENERAL EQUITY PART

Docket No. MER-C-00068-92
Civil Action

STATE FARM MUTUAL AUTOMOBILE INS. CO.,
Plaintiff,

v.

THE STATE OF NEW JERSEY, *et als.*,
Defendants.

ORDER

This matter having been opened to the court by Jamieson, Moore, Peskin & Spicer, P.C., counsel for plaintiff, Thomas P. Weidner, Esq., appearing, in the presence of Edward J. Dauber, Acting Attorney General, counsel for State defendants, Marilyn S. Silvia, Deputy Attorney General, appearing, Francis & Berry, counsel for defendant Marshall Selikoff, Hugh P. Francis, Esq., appearing, and Bressler, Amery & Ross, counsel for defendant PLIGA, J. Michael Riordan, Esq., appearing; and the court having considered all the documentation filed and the oral arguments of counsel, and for the reasons attached hereto;

It is on this 6th day of August, 1992, ORDERED as follows:

1. Plaintiff's motion for partial summary judgment is denied.

2. State defendants' motion to dismiss is denied.

3. Defendant PLIGA's cross-motion to dismiss or for summary judgment is granted because PLIGA is not an indispensable party.

4. Plaintiff's motion for interlocutory relief is denied because there is no clear likelihood of success on the merits at this time, and such relief would create a negative impact on the public interest.

5. Plaintiff's filings regarding the effect of its 1990 surtax and assessment expenditures on its rate of return, are remanded to the Office of Administrative Law which is directed to promptly make the determinations required by this court; in doing so, it shall control any additional minimal discovery which any party may seek so a hearing may be held and a decision forwarded to the Commissioner of Insurance and this Court by September 30, 1992.

/s/ Paul G. Levy
PAUL G. LEVY
P.J.Ch.

Re: State Farm v. State
Docket No. MER-C-00068-92

In *State Farm v. State,* 124 *N.J.* 32 (1991), the Supreme Court held FAIRA facially constitutional, but it anticipated an as-applied challenge. Recognizing that sections 75 and 78 (the PLIGA assessment and the surtax) only prohibit a dollar-for-dollar pass-through to the policyholders, but that they do not operate to deprive an insurance company of its constitutionally protected right to a fair rate of return, *the Department of Insurance* promulgated regulations providing for "separate-rate increase filings by insurers who can demonstrate that payment of the surtaxes and assessments has denied them a fair rate of return," citing *N.J.A.C.* 11:3-16.11(f). 124 *N.J.* at 60. The court concluded that these regulations "allow, if not require, the Commissioner to consider the surtaxes and assessments in affording rate relief to an insurance company otherwise unable to earn a fair rate of return." 124 *N.J.* at 62.

The court foresaw the two problems posed by the within action when it said: "Any arguments based upon actual profits or losses of particular insurers for 1990 would be more appropriately asserted in administrative rate-making proceedings *or as part of an as-applied challenge to the Act,*" and that "the rate application process of *N.J.A.C.* 11:3-16.11 by its very complexity may carry the potential for frustrating in practice the achievement of a fair rate of return." 124 *N.J.* at 62. However, the court concluded that it would "presume that the Commissioner will fulfill his duty under the statute to assure that insurers receive a constitutionally fair rate of return, and will implement the regulations in a realistic and timely manner consistent with that statutory duty." 124 *N.J.* at 62-3.

On May 11, 1990, State Farm applied for "a rate-increase filing . . . [to] demonstrate that payment of the surtax . . . has denied [it] a fair rate of return." State

Farm proposed to place a 5% surcharge on premiums in order to recoup the estimated $13 million surtax for 1990.[1] This was consolidated with State Farm's pending (since March 21, 1990) filing for a "prior approval" rate increase in premiums, and then suspended action on both applications until State Farm supplied further data. On August 24, 1990, State Farm applied for a similar rate-increase concerning the PLIGA assessment, proposing a 2.7 increase on all auto policies for eight years.[2] On October 29, 1990, the DOI unconsolidated the surtax filing from the general prior approval filing and combined the surtax filing with the PLIGA assessment filing; it then suspended action on the new combined filing until even more data was supplied. Finally, after DOI was required by the Appellate Division to comply with an order of this court to proceed with administrative hearings concerning other insurance companies and obtain whatever data it required through the discovery process, the surtax/assessment filing was transmitted by DOI to the OAL in June 1991.

Thus the matter was ripe for the OAL to determine State Farm's fair rate of return, giving consideration to the "actual profits and losses of [State Farm] for 1990" and the effect of the surtax and the PLIGA assessment. In the face of this Supreme Court mandated inquiry, the DOI filed a motion before ALJ McGill to exclude evidence of State Farm's actual 1990 experience! ALJ McGill then granted this motion, holding that the filing was an ordinary prospective needs filing, and being prospective only, "State Farm may not examine profitability data for 1990 retrospectively with a view to recouping past deficiencies, because recoupment would constitute retroactive rate-making."[3] His decision was also based on his

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[1] DOI assigned docket number 90-610 to this filing.

[2] The DOI assigned docket number 90-1056 to this filing.

[3] The Commissioner declined to accept an interlocutory appeal.

finding that State Farm failed to choose 1990 as "the historical period for review of actual results," choosing instead data for 1987 and 1988 from its previous filing.

To prepare for an as-applied constitutional challenge, State Farm must first apply for a determination that payment of the 1990 surtax and assessment prevented it from making a fair rate of return. Its filing in the combination of docket numbers 90-610 and 90-1056 was precisely to determine the effect of these two large expenses on the 1990 rate of return. It is inexplicable how the rate of return for 1990 can be calculated without consideration of evidence of the 1990 profitability. How can a judge determine State Farm's rate of return for 1990, both with and without consideration of the surtax and assessment payments, if State Farm is prevented from presenting its evidence on the basic issue? In its brief supporting its motion to dismiss, the State says:

> There is no dispute, however, that past profitability results, *if introduced in accordance with the regulations*, are part of the *pass-through ratemaking process*.

The underlined qualifications in that statement are mystifying.

This matter should be remanded to the OAL for immediate scheduling and determination of State Farm's rate of return for 1990 without regard to the surtax and assessment expenditures and then with consideration of those expenses. Then the Commissioner will have a basis to determine whether or not there is a constitutionally fair rate of return.[4] If the surtax and assessment cause an inadequate return, the matter of remedy can be de-

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[4] Timeliness is not an issue. In a letter of May 18, 1992 related to a similar filing by Allstate Insurance Co., DAG Silvia advised ALJ Miller that a 1990 filing would not be mooted by the passage of time and that "any rate change which results from this proceeding would be implemented on a prospective basis."

cided administratively.[5] There is no doubt that there is a remedy available if the rate is inadequate, and the Commissioner may not ignore the Supreme Court's direction that he is *required* to afford rate relief under that circumstance. The rubric that "ratemaking is prospective in nature" cannot prevent such relief as would yield a constitutionally fair rate of return.

As to the motions before the court, *State v. State Farm, supra* at 61, recognizes that *N.J.A.C.* 11:3-16.11 is the mechanism for determination of the fair rate of return. That regulation utilizes the procedure of rate relief to make the required determination. Therefore the matter at bar is premature, as the Superior Court should not rule on the taking issues until the administrative determination has been made. The due process claims, based upon timeliness, are intricately involved with the procedures and rulings of the administrative law court; that court's rulings may yet support a claim of liability for delay by the DOI.

Unfortunately, because the specified data had not previously been required in an ordinary rate-increase filing, and because the data was not kept in the ordinary course of an auto insurer's business, filings in the Fall of 1990 were stalled until the Spring of 1992. Determination of a fair rate of return can be made with and without inclusion or surtax and assessment expenditures, and there is no judicial nor legislative direction to make any other consideration than is made in the ordinary rate-increase filing where the insurer is also constitutionally guaranteed a fair rate of return. Of course, since the point is that the relief sought related to 1990 and 1991 profitability and the surtax and assessment expenses in each of those years, consideration would have to be given to the exact effect of those expenditures in the years in question. As

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[5] *N.J.A.C.* 11:3-16.11(f) requires the Commissioner to "determine whether the rates should be adjusted immediately or over time, as may be appropriate."

previously stated, "old ratemaking procedures" and "pass-through ratemaking" are each constitutionally required to provide a fair rate of return to the insurance company.

The Supreme Court envisioned two sources of relief: first, arguments based on actual profitability of an insurer for 1990 would be asserted in a ratemaking proceeding, and if the insurer thought it was not allowed a fair rate of return or timely relief so that the rate adjustment was realistically fair, then a court would consider an as-applied challenge to the application of the statute and the regulations as applied to the administrative procedure. *State Farm v. State, supra,* does not "implicitly recognize that old ratemaking procedures cannot and do not apply to rate requests to reflect FAIR Act surtaxes and assessments," as the DOI argued at the OAL.

Therefore, this matter will be remanded to the OAL for prompt adjudication. The ALJ assigned should require all *usual* data to be pre-filed, on an expedited basis, and then he should determine what the insurer's rate of return was for 1990 and for 1991 and what a fair rate of return was for each of those years. If the achieved rate was not fair, then he should adjust the rates accordingly, for collection in whatever manner he deems reasonable. Depending on the final action at the administrative level,[6] the matter can be reviewed either by this Court or the Appellate Division or both.

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[6] The ALJ should examine the reasons for the delay in processing the pending pass-through filing and explain whether it is usual or unusual for the process to permit the filing to be still undecided.

APPENDIX F

SUPERIOR COURT OF NEW JERSEY
CHANCERY DIVISION—MERCER COUNTY

Docket No. C-000068-92

STATE FARM MUTUAL AUTOMOBILE INSURANCE CO.,
Plaintiff

-V-

STATE OF NEW JERSEY, *et al.*,
Defendants

TRANSCRIPT OF MOTION

DATE: December 3, 1992

* * * *

[40] THE COURT: All right. I am going to grant the State's cross-motion and deny the plaintiff's motion.

I am going to order that the complaint be dismissed.

As I've said during the course of colloquy with Counsel for the plaintiff, I think that everything, except discovery as to the thought processes of the Department of Insurance, has been put in the record at the Administrative—at the Office of Administrative Law.

And that what the plaintiff seeks here is a review by this court of that record.

The claim for losses due to procedural due process follows along with the application for substantive relief which the plaintiff lost.

And since the plaintiff did not prevail, the court has to assume that the surtax and assessment as applied to the

plaintiff were Constitutional in that they permitted the plaintiff to achieve a fair rate of return.

[41] To review the procedures that led to that determination at the administrative level while they—as well as the substantive determination—may be on review to the Appellate Division, I believe are improper.

Now, it may be that if State Farm does not appeal the Commissioner's determination and accepts the ruling that it achieved a fair rate of return—something that I don't imagine they are going to do—in theory, one could say that a trial court could then review the record as to whether or not there was a denial of procedural due process, but to what end?

If the—and I haven't heard this offered yet, but I suppose that if the plaintiff offered to prove that procedures applied to it were so unusual as to being arbitrary or unreasonable, it was entitled to some damages and it could prove in a trial that it spent twice as much time, effort and money as would normally be required in an application such as the one made, that then it might be entitled to one-half of those costs. Unrelated, of course, to the surtax and assessment which this court must presume are valid.

But while everything is still within the period of time—well, let me ask you: Have you applied? Have you filed a notice of appeal?

MR. WEIDNER: Not as of this date, Your Honor.

[42] THE COURT: Well, I get from the expression on your face a few minutes ago that you intend to?

MR. WEIDNER: Well, I would be somewhat surprised if we didn't.

THE COURT: So would I.

Accordingly, I see no reason to keep this matter here.

If I'm wrong—and I have no problem with dealing with the matter if I should deal with it.

If I'm wrong, I know the Appellate Division will rule that way and express exactly what it is that this court

should do vis-a-vis the ruling that will be made on the substantive issue at the level of the Appellate Division.

Accordingly, the entire complaint is dismissed.

Did you submit any form of order on—along those lines?

MS. SILVIA: Yes, Your Honor.

THE COURT: You did? All right. File's complete then.

MR. WEIDNER: Thank you, Your Honor.

MS. SILVIA: Your Honor, if you don't locate the form of order, just if your secretary lets my office know, I'll have another one delivered.

THE COURT: I seem to have something here.

MS. SILVIA: Thank you, Your Honor.

(Whereupon this matter concluded at 10 a.m.)

APPENDIX G

[Filed Dec. 3, 1992]

SUPERIOR COURT OF NEW JERSEY
CHANCERY DIVISION—MERCER COUNTY

Docket No. MER-C-000068-92
Civil Action

STATE FARM MUTUAL AUTOMOBILE INS. CO.,
Plaintiff,

v.

THE STATE OF NEW JERSEY, *et als.*,
Defendants.

ORDER

This matter having been opened to the Court by Edward J. Dauber, Acting Attorney General of New Jersey, attorney for the State Defendants (Marilyn S. Silvia, Deputy Attorney General, appearing), on notice to all counsel of record; and the Court having reviewed the moving and supporting papers, and all papers filed in response thereto; and the Court having heard the arguments of counsel; and for good cause shown;

IT IS on this 3rd day of December, 1992,

ORDERED that the Complaint in this matter shall be, and hereby is, dismissed with prejudice and in its entirety for the reasons set forth on the record on December 3, 1992.

/s/ Paul G. Levy
PAUL G. LEVY
P.J.Ch.

APPENDIX H

PERTINENT CONSTITUTIONAL AND STATUTORY PROVISIONS

The Fifth Amendment to the United States Constitution provides, in pertinent part: "nor shall private property be taken for public use without just compensation."

The Fourteenth Amendment to the United States Constitution provides, in pertinent part: "nor shall any State deprive any person of life, liberty, or property, without due process of law."

The Fair Automobile Insurance Reform Act, L. 1990, c.8, codified at N.J.S.A. §§ 17:33B-1 (1994) *et seq.* and §§ 17:30A (1994) *et seq.*, provides in pertinent part:

17:33B-1. Short title

This act shall be known and may be cited as the "Fair Automobile Insurance Reform Act of 1990."

17:33B-2. Legislative findings and declaration

The Legislature finds and declares that:

a. For almost two decades the system of motor vehicle insurance in this State has been the subject of examination, reform, review and revision in all three branches of government.

b. The common public purpose throughout this period has been to provide to the motorists of this State a comprehensive program of indemnification from the injuries and damages that may arise out of the ownership or operation of motor vehicles that is equitable, efficient and economical.

c. As various legislative or executive initiatives were taken in pursuit of this public purpose, the insurance industry itself, and the businesses and professions that provide goods and services to those involved in motor ve-

hicle accidents, were at the same time altering the way in which they conducted their businesses to respond to a changing business and regulatory climate to ensure that they continued to benefit.

d. It has become increasingly obvious to the Legislature and the public that, as a result, one of the principal goals of this common purpose has not been attained: economy. Not only has the cost of the insurance product itself escalated, but the subsidies that most drivers contribute to support the financially-troubled New Jersey Automobile Full Insurance Underwriting Association have made the system a burden, rather than a benefit, to the citizens of the State.

e. The current law developed through legislative initiative, executive administration and judicial interpretation for: (1) the underwriting and rating of motor vehicle insurance; (2) the apportionment of drivers between a voluntary and residual market based on their characterization as "good" or "bad" drivers; (3) the provision of health care services and motor vehicle repair; (4) the payment of claims and protection of the rights and remedies of those injured or damaged; and (5) the regulation and financing of this system, and its many aspects, is cumbersome, complex, and confusing and allows for and encourages inefficiency, waste, mismanagement and the potential for misuse of public and private moneys.

f. As a result of this experience, the Legislature finds that it is necessary to address the myriad aspects and issues of this complicated and interrelated system, not through piecemeal adjustment of various statutory or regulatory provisions, but through a logical, comprehensive and complete revision of the various laws and regulatory schemes that impact, in whatever fashion, on the system and its participants.

g. To provide a healthy and competitive automobile insurance system in this State, automobile insurers are

entitled to earn an adequate rate of return through the ratemaking process.

h. To that end, the Legislature declares that it is in the public interest to:

(1) revise the basic options and coverages available under automobile insurance policies, including the option to make one's health insurance the primary source for payment of medical and hospital expenses;

(2) eliminate, over time, the current residual market mechanism, the New Jersey Automobile Full Insurance Underwriting Association, and certain of the market subsidies currently funding its losses;

(3) provide, through the appointment of an insolvency trustee, for the orderly evaluation, prioritization and satisfaction of obligations payable on behalf of the association;

(4) provide, through assessments on property-casualty insurers, a surtax on the premium taxes of automobile insurers, temporary assessments for the privilege of practicing certain professions and occupations, temporary and minimal increases in certain motor vehicle registration fees, as well as continuation of merit rating surcharges, for the funding of the debts and obligations of the association;

(5) create a new residual market mechanism in which insurers will share directly in the risk of insuring the "bad driver";

(6) guarantee that "good drivers" secure motor vehicle insurance coverage in the voluntary market and control the apportionment of drivers in the residual market;

(7) eliminate anti-competitive aspects of the current rating laws as they apply to automobile insurers and completely eliminate combinations among automobile insurers for rate-making purposes;

(8) promote the efficient handling of claims and the elimination of fraud and other deceptive practices; and

(9) promote the participation of the insurance consumer in reducing losses through the installation and use of anti-theft devices, the successful completion of defensive driving courses, and similar activities.

17:33B-3. New Jersey automobile full insurance underwriting association; trustee; plan of operation

a. The Legislature finds that the New Jersey Automobile Full Insurance Underwriting Association, created pursuant to section 16 of P.L.1983, c. 65 (C.17:30E-4), is currently operating in a substantially impaired financial state with an operating deficit which the association has estimated to be in excess of $3 billion and that, based upon the results of a recent claim and underwriting review and financial audit, the Commissioner of Insurance stated that mismanagement by the insurance companies acting as servicing carriers cost the association $908 million between its inception in 1984 and 1988. The Legislature further finds that the association is not earning new premium income or collecting subsidies in an amount sufficient to pay its claims and expenses. The Legislature further finds that under the above enumerated circumstances the association, if it were a licensed insurer, would likely be declared financially impaired or insolvent pursuant to the provisions of P.L.1975, c. 113 (C.17:30C-1).

b. Therefore,

(1) Within 90 days of the effective date of this 1990 amendatory and supplementary act, the commissioner shall appoint a trustee, who shall be a person experienced in insolvency or bankruptcy, who shall not, during his tenure as trustee be affiliated with or employed by an insurer. The trustee shall serve at the pleasure of the commissioner and shall be paid from funds available to the New Jersey Automobile Insurance Guaranty Fund created pursuant to section 23 of this act, in an amount and manner as determined by the commissioner. The trustee shall carry out his obligations as provided in this act and the plan of

operation promulgated pursuant to paragraph (2) of this subsection.

(2) The trustee shall, as soon as possible upon appointment, promulgate a plan of operation to be approved by the commissioner. Pursuant to the plan of operation, the trustee shall have the authority to disburse funds made available from the New Jersey Automobile Insurance Guaranty Fund pursuant to section 23 of this act and such other monies as may be appropriated to or otherwise made available to the fund or the association, including those monies collected by the association pursuant to section 20 of P.L.1983, c. 65 (C.17:30E-8), on behalf of the association for the payment of claims and other financial obligations of the association, including the contracts with the servicing carriers. The plan shall provide for the payment of covered losses on behalf of the association. Among other things necessary to the orderly evaluation, prioritization and disbursement of monies payable on behalf of the association, the plan shall contain a schedule for the prioritization of claims payments by the type of claim for which payment is due. The schedule may provide for the deferral of the payment of residual bodily injury losses over a period not to exceed four years. The schedule may also provide for the deferral of other payments only upon certification by the commissioner that the fund cannot by any other available means secure the monies necessary to pay those losses. However, the plan shall not provide for the deferral of payment of damages which are due and payable for present economic loss under any circumstance.

(3) The trustee shall report to the commissioner biannually, or more frequently if ordered by the commissioner, on the financial condition of the association and the disbursement of funds pursuant to the plan of operation. The commissioner shall make an annual report on the activities of the trustee to the Legislature and the Governor. The report shall contain an accounting of the immediately preceding annual period, including a report of the financial obligations attributable to the association;

the income available to and the disbursements made by the trustee during that period; and a projection of the financial obligations, anticipated income and expected disbursements for the immediately succeeding annual period.

(4) In fulfilling his duties pursuant to this subsection, the trustee shall avail himself of the services of association staff and shall utilize association procedures, equipment and supplies to the extent such use facilitates fulfillment of the trustee's duties. The trustee shall have the authority to continue any audit being conducted with regard to the operations of the association and to conduct such audits.

* * * *

17:33B-5. New Jersey automobile insurance guaranty fund

a. There is hereby created within the General Treasury a special nonlapsing fund to be known as the New Jersey Automobile Insurance Guaranty Fund. The State Treasurer shall credit to the fund, in addition to any sums appropriated thereto, all monies designated in subsection b. of this section and collected pursuant to this act on and after the effective date of this 1990 amendatory and supplementary act. Monies credited to the New Jersey Automobile Insurance Guaranty Fund may be invested in the same manner as assets of the General Fund and any investment earnings on the fund shall accrue to the fund and shall be available subject to the same terms and conditions as other monies in the fund. The State Treasurer may determine the amount of earnings to be credited to the New Jersey Automobile Insurance Guaranty Fund to reflect the average rate of return on the State of New Jersey Cash Management Fund.

b. Monies from the following sources shall be credited by the State Treasurer to the New Jersey Automobile Insurance Guaranty Fund: the revenues attributable to the surtax imposed under section 76 of this 1990 amendatory and supplementary act (C.17:33B-49); the revenues attributable to the tax imposed on premiums earned by the

New Jersey Automobile Full Insurance Underwriting Association pursuant to section 34 of P.L.1983, c. 65 (C.17:30E-22); that percentage of surcharges collected by the Division of Motor Vehicles on or after October 1, 1991, pursuant to subsection b. of section 6 of P.L.1983, c. 65 (C.17:29A-35); monies collected by the Division of Motor Vehicles on or after October 1, 1991, pursuant to section 68 of this 1990 amendatory and supplementary act (C.17:33B-63); monies collected by the State Board of Medical Examiners pursuant to section 63 of this 1990 amendatory and supplementary act (C.17:33B-58); monies collected by the State Board of Chiropractic Examiners pursuant to section 64 of this 1990 amendatory and supplementary act (C.17:33B-59); monies collected by the State Board of Physical Therapy pursuant to section 65 of this 1990 amendatory and supplementary act (C.17:33B-60); monies collected by the Division of Motor Vehicles pursuant to section 66 of this 1990 amendatory and supplementary act (C.17:33B-61); monies collected by the State Treasurer pursuant to section 67 of this 1990 amendatory and supplementary act (C.17:33B-62); loans made to the fund as provided in subsection c. of this section; and such other income as may be deposited with or otherwise made available to the New Jersey Automobile Full Insurance Underwriting Association on or after October 1, 1991, including monies deposited in the New Jersey Automobile Full Insurance Underwriting Association Auxiliary Fund pursuant to section 5 of P.L.1983, c. 320 (C.17:33A-5).

c. (1) The fund shall borrow such monies as are made available by the New Jersey Property-Liability Insurance Guaranty Association pursuant to paragraph (10) of subsection a. of section 8 of P.L.1974, c. 17 (C.17:30A-8).

(2) The fund may, upon the approval of the Commissioner of Insurance and pursuant to terms and conditions established by him, borrow monies from any other available source.

d. The monies in the New Jersey Automobile Insurance Guaranty Fund, including interest earnings thereon, are specifically dedicated and shall be utilized exclusively for the costs of the purposes of satisfying the financial obligations of the New Jersey Automobile Full Insurance Underwriting Association, as provided in this 1990 amendatory and supplementary act. Those monies are hereby appropriated for those purposes; provided, however, that those monies shall be disbursed by the State Treasurer as provided in subsection e. of this section.

e. The trustee appointed pursuant to section 21 of this 1990 amendatory and supplementary act shall prepare a written application for any disbursement of monies from the New Jersey Automobile Insurance Guaranty Fund, specifying the amount of the disbursement, the intended expenditures, and the manner in which such expenditures serve the purposes of the trustee's function and this act. The application shall be submitted to the Commissioner of Insurance for approval. Upon approval by the commissioner, the application shall be forwarded to the State Treasurer for approval. Upon approval by the State Treasurer, he shall disburse monies from the New Jersey Automobile Insurance Guaranty Fund to the trustee for disbursement as provided in the approved application.

* * * *

17:33B-49. Annual surtax on premiums; payment

a. In addition to the tax on net premiums paid pursuant to section 1 of P.L.1945, c. 132 (C.54:18A-1), each taxpayer under that section shall pay to the Director of the Division of Taxation an annual surtax at a rate of 5%, or a rate adjusted pursuant to section 77 [17:33B-50] of this 1990 amendatory and supplementary act, on all taxable premiums collected in this State, except premiums collected by the New Jersey Automobile Full Insurance Underwriting Association created pursuant to section 16 of P.L.1983, c. 65 (C.17:30E-4), and premiums col-

lected by the Market Transition Facility created pursuant to section 88 of P.L.1990, c. 8 (C.17:33B-11), in calendar years 1990, 1991 and 1992 for contracts of automobile insurance, notwithstanding section 6 of P.L. 1945, c. 132 (C.54:18A-6). The surtax shall be administered pursuant to the provisions of P.L.1945, c. 132 (C.54:18A-1 et seq.), except that if any provision of that act is in conflict with a specific provision of this 1990 amendatory and supplementary act, the provision or provisions of this 1990 amendatory and supplementary act shall govern.

b. For the purposes of sections 76 through 78 [17:33B-49 to 17:33B-51] of this 1990 amendatory and supplementary act:

"Automobile" means a private passenger automobile of a private passenger or station wagon type that is owned or hired, and is neither used as a public or livery conveyance for passengers nor rented to others with a driver; a motor vehicle with a pickup body, a delivery sedan, a van, or a panel truck or a camper type vehicle used for recreational purposes, owned by an individual or by husband and wife who are residents of the same household, not customarily used in the occupation, profession or business of the insured other than farming or ranching. An automobile owned by a farm family copartnership or corporation, which is principally garaged on a farm or ranch and otherwise meets the definition contained in this section, shall be considered a private passenger automobile owned by two or more relatives resident in the same household; and

"Automobile insurance" means direct insurance against injury or damage, including the legal liability therefor, arising out of the ownership, operation, maintenance or use of an automobile, including, but not limited to, personal injury protection insurance, bodily injury liability insurance, property damage liability insurance, physical damage insurance and uninsured and underinsured motorist insurance.

c. Each taxpayer shall:

(1) on or before the first day of the third month following enactment of this 1990 amendatory and supplementary act make an installment payment of surtax due under subsection a. of this section in an amount equal to one half of the surtax estimated to be due for taxable premiums collected in this State in calendar year 1990 if the surtax rate at the time of the payment was imposed for the entire year; and

(2) on or before the first day of the sixth month following enactment of this 1990 amendatory and supplementary act, make an installment payment of surtax due under subsection a. of this section in an amount equal to one half of the surtax estimated to be due for taxable premiums collected in this State in calendar year 1990 if the surtax rate at the time of the payment was imposed for the entire year; provided however, that no installment payment shall be due if the payment date of such installment pursuant to this subsection falls on or after February 1, 1991.

In the calculation of the tax due in accordance with subsection a. of this section, a taxpayer shall be entitled to a credit in the amount of the tax paid under this subsection as a partial payment and shall be entitled to the return of any amount so paid which is in excess of the total amount payable in accordance with this section.

d. Failure to pay any installment payment required pursuant to subsection c. of this section shall constitute a deficiency, and there shall be added to the tax for the calendar year interest on the amount of underpayment as provided in the State Tax Uniform Procedure Law, R.S.54:48-1 et seq., for the period of the underpayment.

The amount of underpayment shall be the excess of the amount of the installment payment which would be required to be paid if the installment payment were equal to 45% of the surtax which would be shown on the

return for the year if the surtax rate at the time of the payment were imposed for the entire year, or if no return was filed, 45% of the tax for that year, over the amount, if any, of the installment payment paid on or before the last date prescribed for payment.

For purposes of this subsection, the period of the underpayment shall run from the date the installment payment was required to be paid to the earlier of the date on which the surtax is due pursuant to subsection a. of this section or, with respect to any portion of the underpayment, the date on which that portion is paid.

For purposes of this subsection, a payment of any installment payment shall be considered a payment of any previous underpayment only to the extent that such payment exceeds the amount of the installment determined under this subsection for that installment payment.

e. All revenues collected from the surtax imposed pursuant to this section, less any refunds paid pursuant to subsection d. of section 77 of this 1990 amendatory and supplementary act, shall be credited by the State Treasurer to the New Jersey Automobile Insurance Guaranty Fund, created pursuant to section 23 of this 1990 amendatory and supplementary act.

17:33B-50. Adjustment of rate of surtax; estimate of revenues; refund of excess

a. The Director of the Division of Taxation is hereby authorized to adjust the rate of the surtax imposed pursuant to section 76 [17:33B-49] of this 1990 amendatory and supplementary act, for any of the calendar years in which the surtax is imposed, as provided in this section.

b. The Director of the Division of Taxation, in consultation with the Commissioner of Insurance, shall, on or before the first day of the second month following enactment of this 1990 amendatory and supplementary act, prepare an estimate of the revenues anticipated to

be collected from the surtax imposed pursuant to section 76 of this 1990 amendatory and supplementary act, at the rate established thereby, and credited to the New Jersey Automobile Insurance Guaranty Fund, for each of the three calendar years in which the surtax is imposed. These estimates shall be reviewed and, if appropriate, revised, on or before the first day of the month immediately preceding the due date for the second installment payment for the first calendar year in which the surtax is imposed and each subsequent installment payment and each final payment required to be made pursuant to section 76 of this 1990 amendatory and supplementary act. Such review and revision shall be based upon information available to the director and the commissioner, including actual surtax collections as reflected in final payments.

c. At any time that the estimates prepared and revised pursuant to subsection b. of this section reflect total estimated surtax revenues in excess of, or significantly less than, $300,000,000 for the three calendar years in which the surtax is imposed, the director shall provide that the surtax be imposed at a different rate, such that the total estimated revenues are as near as possible to, but do not exceed, $300,000,000, provided, however, that the rate shall not exceed 5%. That different surtax rate shall be imposed on premiums collected in the first calendar year for which final returns and final payments have not yet been made and, subject to the director's determination, may be reflected in installment payments which have not yet been made.

d. On or before April 1, 1993, the director shall make a final determination of the total amount of revenues collected under the surtax imposed pursuant to section 76 of this 1990 amendatory and supplementary act for the three calendar years in which the surtax is imposed. The director shall refund any such revenues collected in excess of $300,000,000 to taxpayers in proportion to each taxpayer's share of total surtax payments made for the three calendar years.

17:33B-51. Policyholders not to pay surtax

The Commissioner of Insurance shall take such action as is necessary to ensure that private passenger automobile insurance policyholders shall not pay for the surtax imposed pursuant to section 76 [17:33B-49] of this 1990 amendatory and supplementary act.

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17:30A-8. Obligations, duties and powers

a. The [Property Liability Insurance Guaranty] association shall:

* * * *

(9) Assess member insurers in amounts necessary to make loans pursuant to paragraph (10) of this subsection. The estimated assessments of each member insurer shall be in the proportion that the net direct written premiums of the member insurer for the calendar year preceding the assessment bears to the net direct written premiums of all member insurers for the calendar year preceding the assessment with actual assessments adjusted in the succeeding year based on the proportion that the assessed member insurer's net direct written premiums in the year of assessment bears to the net direct written premiums of all member insurers for that year. For the purposes of this paragraph, "net direct written premiums" shall not include medical malpractice liability insurance premiums paid to member insurers to which an additional charge has been applied for deposit in the New Jersey Medical Malpractice Reinsurance Recovery Fund as provided in the "Medical Malpractice Liability Insurance Act," P.L. 1975, c. 301 (C. 17:30D-1 et seq.) and the regulations promulgated pursuant thereto;

(10) Make loans in the amount of $160 million per calendar year, beginning in calendar year 1990, to the New Jersey Automobile Insurance Guaranty Fund created pursuant to section 23 of P.L.1990, c. 8 (C.

17:33B-5), except that no loan shall be made pursuant to this paragraph after December 31, 1997.

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17:30A-16. Recoupment of assessments by surcharge on premiums; amount

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b. No member insurer shall impose a surcharge on the premiums of any policy to recoup assessments paid pursuant to paragraph (9) of subsection a. of section 8 of P.L.1974, c. 17 (C.17:30A-8).

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